

**Political Risk and Chinese Investments  
in the African Oil and Gas Industry:  
The Case of China National Petroleum Corporation in South Sudan**

by  
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## **Declaration**

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## Abstract

Chinese national oil corporations have increased their foreign direct investments over the last decade in Africa, where the political environment of oil producing countries often expose the firms to high political risk. The analysis of political risk is increasingly relevant for the investment decision-making process of Chinese corporations, as changes in political dynamics of host countries can affect the opportunities and profitability of investments. The study emphasises the need for firm-specific political risk analysis as a decision-making tool for international businesses operating in foreign countries.

The main research question of the study is concerned with the main indicators of political risk that Chinese corporations may face in the African oil and gas industry. Chinese oil corporations may be affected by political instability, international and internal conflict, corruption, and poor economic and social development in African countries. The political risk they face may be influenced by indicators such as the location of the oil operations, the relative importance of the Chinese oil firm to the host country's oil industry, the competitive advantage and technical abilities of Chinese oil firms, the support of the Chinese government to state-owned firms, and economic relations that the host government have with China and the oil firm.

The study follows a qualitative research approach by way of an empirical case study of the political risk faced by one of China's national oil corporations, China National Petroleum Corporation (CNPC), in South Sudan. A major part of CNPC's business operations in Sudan was transferred to South Sudan after the country seceded from Sudan in July 2011. The political risk for CNPC in South Sudan is analysed and measured in accordance with an industry-specific political risk model for the oil and gas industry. The study finds that CNPC faces a high level of political risk in South Sudan since independence.

An examination of the political risk analysis is done to serve as a basis for answering the main research question. The hostile relationship between South Sudan and Sudan in particular may expose CNPC to high political risk as it led to the shutdown of the oil industry and violent interstate conflict. However, CNPC's political risk exposure may be mitigated by certain indicators, such as CNPC's significance in the operation of the South Sudanese oil industry, CNPC's attributes of being a Chinese state-owned enterprise, the availability of support from the Chinese government in the form of economic cooperation packages and CNPC's technical abilities in exploration operations. Furthermore, while negative sentiments on the part of the South Sudanese government towards China and CNPC due to the latter's close relations with Sudan might expose CNPC to high risk, the risk is mitigated by the high level of economic dependency of South Sudan on both China and CNPC.

## Opsomming

In die laaste dekade het Chinese nasionale oliekorporasies hulle buitelandse direkte beleggings in Afrika uitgebrei. Die politieke omgewing van hierdie lande veroorsaak egter dikwels dat hierdie firmas aan hoë politieke risiko blootgestel word. Omdat politieke dinamiek in gasheerlande die geleenthede en winsgewendheid van beleggings kan affekteer, is die analise van politieke risiko toenemend relevant in die beleggingsbesluitnemingsproses van Chinese oliekorporasies.

Die hoof-navorsingsvraag in hierdie studie handel oor die hoofindikatore van politieke risiko waaraan hierdie korporasies in Afrika se olie- en gasindustrie blootgestel kan word. Politieke onstabiliteit, internasionale en nasionale konflik, korrupsie, asook swak ekonomiese en sosiale ontwikkeling in Afrikalande kan Chinese oliekorporasies affekteer. Die politieke risiko waaraan hulle blootgestel word, kan beïnvloed word deur faktore soos die ligging van oliebedrywighede, die relatiewe belangrikheid van die Chinese oliekorporasie vir die gasheerland se olie-industrie, die kompeterende voordeel en tegniese vermoëns van die Chinese oliekorporasies, die Chinese regering se ondersteuning van staatskorporasies en die ekonomiese verhoudings wat die gasheerland met China en die oliefirmas het.

Die studie volg 'n kwalitatiewe navorsingsbenadering by wyse van 'n empiriese gevallestudie van die politieke risiko waaraan een van China se nasionale oliekorporasies, China National Petroleum Corporation (CNPC), in Suid-Soedan blootgestel word. Sedert Suid-Soedan se onafhanklikheidswording in Julie 2011 is die grootste gedeelte van CNPC se bedrywighede in Soedan na Suid-Soedan oorgedra. Die politieke risiko vir CNPC is volgens 'n industrie-spesifieke politieke risiko-model geanaliseer en bereken. Die studie toon dat CNPC inderdaad aan 'n hoë vlak van politieke risiko blootgestel is sedert onafhanklikheid.

Die politieke risiko-analise word ondersoek ten einde as basis te dien vir die beantwoording van die hoof-navorsingsvraag. In die besonder kan die vyandiggesinde verhouding tussen Suid-Soedan en Soedan CNPC blootstel aan hoë politieke risiko, onder andere vanweë die sluiting van die olie-industrie en die gewelddadige interstaat-konflik wat dit meegebring het. CNPC se blootstelling aan politieke risiko kan egter verminder word deur sekere faktore soos CNPC se beduidende belangrikheid in die bedryf van die Suid-Soedanese olie-industrie, CNPC se kenmerke as 'n Chinese staatsonderneming, die beskikbaarheid van die ondersteuning van die Chinese regering in die vorm van ekonomiese samewerkingspakette asook CNPC se tegniese vermoëns in die veld van eksploratiebedrywighede. Alhoewel die negatiewe sentiment in die Suid-Soedanese regering teenoor China en CNPC as gevolg van hulle noue verbintenis met Soedan vir CNPC aan hoë risiko kan blootstel, word hierdie risiko verminder deur Suid-Soedan se hoë vlak van ekonomiese afhanklikheid van CNPC en China.

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## List of acronyms

AU	African Union
AUHIP	African Union High Level Implementation Panel
AUPSC	African Union Peace and Security Council
BMI	Business Monitor International
CNOOC	China National Offshore Oil Corporation
CNPC	China National Petroleum Corporation
COMESA	Common Market for Eastern and Southern Africa
CPA	Comprehensive Peace Agreement
CPC	Communist Party of China
DDR	Disarmament, Demobilisation and Reintegration
DRC	Democratic Republic of the Congo
GDP	Gross Domestic Product
GNOP	Greater Nile Oil Pipeline
GNI	Gross National Income
GNPOC	Greater Nile Petroleum Operating Company
GNU	Government of National Unity
GoSS	Government of Southern Sudan
EAC	East African Community
ECOS	European Coalition on Oil in Sudan
EIA	Energy Information Administration
EPSA	Exploration and Production Sharing Agreement
EU	European Union
FDI	Foreign Direct Investment
FOCAC	Forum on China-Africa Cooperation
IGAD	Intergovernmental Authority on Development
ICG	International Crisis Group
IMF	International Monetary Fund
IR	International Relations
MEM	Ministry of Energy and Mining
MFA	Ministry of Foreign Affairs
MNC	Multinational Corporation
MOFCOM	Ministry of Commerce
NCP	National Congress Party



NDRC	National Development and Reform Commission
NGO	Non-Governmental Organisation
NIF	National Islamic Front
NOC	National Oil Corporation
OECD	Organisation for Economic Cooperation and Development
ONGC	Oil and Natural Gas Corporation
OPRR	Overall Political Risk Rating
PCA	Permanent Court of Arbitration
PDOC	Petrodar Operating Company
PE	Political Economy
SAF	Sudanese Armed Forces
SASAC	State Asset Supervision and Administrative Commission
SHSBA	Sudan Human Security Baseline Assessment
SOE	State-Owned Enterprise
SPLM/A	Sudan People's Liberation Movement/Army
SPLM-N	Sudan People's Liberation Movement - North
SSNBS	South Sudan National Bureau of Statistics
TFA	Transitional Financial Arrangement
TNC	Transnational Corporation
UAE	United Arab Emirates
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNMISS	United Nations Mission in South Sudan
UNOCHA	United Nations Office of the Co-ordination of Humanitarian Affairs
UNSC	United Nations Security Council
US	United States
WB	World Bank
WTO	World Trade Organisation

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## Chapter One: Introduction to the study

### 1.1 Introduction and statement of the topic

Characterised by increased global economic integration, capital mobility and energy demand, the last few decades have seen the rise of new actors in the global business environment. As they are integrating into the world economy, developing countries such as China, India and Brazil are not only increasingly recipients of foreign direct investment (FDI) inflows, they have also become a major source of FDI outflows. Many of these FDI outflows from developing countries have gone to African countries, which have become an important source of oil to satisfy the growing world energy demand. This is particularly the case with China, which is now the second largest oil consumer in the world (Ma, Fu, Li & Liu, 2012:45). Africa is the source of 30 percent of China's oil imports (Alessi & Hanson, 2012), with Angola as its main supplier (Croll, Lebzien & Paes, 2008:2). The major part of Chinese FDI outflows to Africa has gone to oil-rich countries such as Nigeria, Algeria and Sudan (Ministry of Commerce (MOFCOM) of the People's Republic of China, 2011:90). The United Nations Conference on Trade and Development (UNCTAD, 2012:xvi) reports that developing countries have increased their share of investments in Africa relative to developed countries over the last year. FDI by developed countries is constrained by the world economic downturn and the European debt crisis, and the political instability in African countries like Egypt and Libya made Africa less attractive as an investment destination. China on the other hand, has large foreign currency reserves (Deng, 2009:77) and seems willing to invest in African countries with unstable political environments. However, even if Chinese firms seem less risk-averse than their Western counterparts, the political environment may affect their business operations. For example, in 2011 more than 30 000 Chinese workers had to be evacuated from Libya during the political conflict (International Crisis Group (ICG), 2012a:9). Chinese firms can therefore not afford to ignore political risk. Jakobsen (2010:482) argues that the "risk landscape" of the 21<sup>st</sup> century is different from the previous century as more political actors are involved and the world is increasingly interconnected. Bremmer and Keat (2009:3) remark that this increased global economic integration, together with growing political instability, "have created a climate in which political risk is more relevant than ever for companies and governments". While the key political risk that foreign investors faced during the 1960s and 1970s was expropriation, Jakobsen (2010:482) argues that political risk today is a "highly complex and multidimensional phenomenon".

Apart from political instability such as the North Africa uprisings in 2011, foreign business firms operating in African countries may be exposed to political risk caused by wars, external threats, labour unrest and terrorism, or subtler political actions such as government

regulation or taxation policies. For oil corporations Alon, Gurumoorthy, Mitchell and Steen (2006:631) add the risks of energy vulnerability, oil embargoes or restrictions on oil exports. Frynas and Mellahi (2003:544) argue that these political risks can impact firms differently because of factors such as the firm's historical advantage, technical abilities, high-level connections with the local government, nationality or the firm's approach to community interaction (Frynas & Mellahi, 2003). This is in line with Alon and Herbert's (2009:128) argument that "specific aspects of the firm either increase or decrease its political risk exposure".

The focus of this study will be on the political risk that Chinese business firms may face in the oil and gas industry in African countries. The risk landscape of the new millennium have changed as more actors are now involved in the African oil and gas industry, and although Chinese oil firms are relative latecomers in the field, they play an increasingly important role in Africa. With growing energy demands, oil and gas exports have become a major source of revenue for many African countries, and these countries are now much more integrated into the world economy. Africa has gained relative prominence in China's foreign relations since the new millennium, especially in terms of economic relations, and political risk has become relevant for Chinese firms.

This study will be an expansion of the research done by scholars such as Frynas and Mellahi (2003) and Alon and Herbert (2009) on firm-specific political risk. A case study approach will be followed by focussing on South Sudan, an African oil-producing country that seceded from Sudan<sup>1</sup> in July 2011. A significant part of the investments of the largest investor in the Sudanese oil industry, the Chinese national oil corporation (NOC) China National Petroleum Corporation (CNPC), was transferred to South Sudan after independence because 75 percent of the oil fields of Sudan fell into the territory of the new state. These two countries remain economically interdependent because the landlocked South Sudan can only export its oil through Sudan's infrastructure (Medani, 2011:136). However, unresolved issues of the Comprehensive Peace Agreement (CPA), that brought peace to Sudan in 2005 after 22 years of civil war, led to the renewal of the hostile relationship between Juba and Khartoum<sup>2</sup>. The direct consequences of these unresolved issues between Sudan and South Sudan was firstly the decision of the South Sudanese government to shut down its oil production at the beginning of 2012 (McNamee, 2012:12) and secondly the outbreak of armed conflict between the two states during April 2012

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<sup>1</sup> In this study the term Sudan refers to the country with Khartoum as the capital and South Sudan refers to the new country with Juba as the capital. The term southern Sudan is used to describe the southern region of Sudan prior to secession. When describing events that took place prior to the secession of South Sudan, the term Sudan refers to the

<sup>2</sup> In this context Khartoum refers to the government agencies of Sudan while Juba refers to the government agencies of South Sudan since 9 July 2011 and to the government agencies of the semi-autonomous Southern Sudan for the period from 9 January 2005 to 8 July 2011.

because of disputes around the demarcation of the border. By way of a political risk analysis this study will measure the level of political risk that the political environment and events in South Sudan may pose to CNPC.

In the remainder of this chapter the research problem and the research question will be formulated as well as an explanation of the objectives, rationale and significance of the study. Thereafter the research design and methodology will be described, followed by an overview of the important literature that will be consulted during the research, and a discussion of the limitations and delimitations of the study. Before concluding this section, an outline of the rest of the study will be provided.

## **1.2 Research problem and research questions**

The relationship between business and politics is not only acknowledged in the field of Political Risk Analysis, but is also a subject of study in other disciplines such as International Relations (IR), Foreign Policy Analysis and Political Economy (PE). While Keohane and Nye (1971:330) emphasise the role of non-state actors such as multinational corporations (MNCs) in world politics, Beasley, Kaarbo, Lantis and Snarr (2002:8) make the specific comment that poor states on the periphery of the international economic system are often constrained in their foreign policy because of their extreme dependency on other states, MNCs and international financial institutions. In the field of PE, Stopford and Strange (1991:1) argue that firms and governments are mutually interdependent in a globalised world, as governments compete to attract FDI and firms become dependent on governments as they compete with other firms across national borders. Government diplomacy therefore increasingly extends beyond state to state relations to include relations with MNCs (Stopford & Strange, 1991:2; Hill, 2003:xix). In the field of Political Risk Analysis, Frynas and Mellahi (2003:541) have a similar line of argument to emphasise the importance of firm-specific political risk. They argue that international firms are not merely “passive bystanders” influenced by the political environment in which they operate, but they can be active actors in shaping that environment or in exploiting it for their own benefit (Frynas and Mellahi, 2003:541,562). For Brink (2004:181) this is especially the case with international firms operating in developing countries where the host government is dependent on the MNC for economic development. This relationship gives the MNC some bargaining power that can be used to benefit the firm or mitigate the effect of political risk (Brink, 2004:181). Recognising that the nature of political risk is highly complex, Frynas and Mellahi (2003) argue that firms or projects are differently affected by political risk exposure in a country because of variables that give the firm a bargaining advantage, such as the firm’s nationality and the firm’s relations with the host government. It is because of the particularity of international firms and the

industry in which they operate that scholars such as Frynas and Mellahi (2003:561) and Alon and Herbert (2009:127) suggest that more research is necessary in the area of micro political risk<sup>3</sup>.

As Chinese corporations are expanding their investments in the African oil and gas industry, Cissé (2012:4) comments that the opportunities for Chinese investors are often in high-risk zones. These business operations of the Chinese oil corporations might be exposed to macro political risks<sup>4</sup> such as wars or civil unrest that may affect all businesses in a country, but may also be exposed to micro political risks such as oil embargoes or environmental activism that are specific to the oil and gas industry. It is also possible that Chinese firms are affected by these risks in different ways to other corporations because of risk indicators such as the firm's relations with the host government or its historical advantages in a certain country, as Frynas and Mellahi (2003) suggest. While Frynas and Mellahi (2003:541,562) argue that firms can mitigate their political risk exposure by playing a role in the shaping of the political environment or exploit the high-risk situation, this might be the case with Chinese NOCs. According to Alden, Large and Soares de Oliveira (2008:20), Chinese NOCs increasingly shape Chinese relations with Africa. This links up with Zhu's (2010:22) observation that Chinese businesses play a role in political relations with Africa as bankers and businesspeople often accompany Chinese government officials on trips to Africa to promote commerce. Barber and Xiao (2012:6) remark that "Chinese interests become ever more entrenched and consequently caught up in Africa's domestic and regional politics" despite Chinese official rhetoric of "non-interference"<sup>5</sup> in the internal affairs of other countries. This study will examine the proposition that Chinese oil firms operating in Africa may not only be exposed to firm-specific political risk, but that these firms may also play a role in shaping or exploiting the political environment in which they operate. It is the aim of this study to identify the main indicators<sup>6</sup> of political risk that Chinese corporations may face in the African oil and gas industry. From this discussion, the main research question that will be guiding the study is the following:

- What are the main indicators of political risk that Chinese corporations may face in the oil and gas industry in African countries?

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<sup>3</sup> While macro political risk refers to risks that affect the majority of foreign operations and investments in a host country, micro political risk is discriminative in the sense that only a selected group is affected, such as a certain industry, firm or project (Alon & Herbert, 2009:129,130). The term macro and micro political risk will be conceptualised in section 2.3.6.

<sup>4</sup> Refer to footnote 3 for an explanation of macro political risk.

<sup>5</sup> The principle of non-interference in the affairs of other countries and respect for their sovereignty is a guiding principle in China's international relations. Also refer to the discussion in section 3.3.

<sup>6</sup> The terms risk factors and indicators are used in this study in accordance with the use in Boshoff's industry-specific political risk model for the oil and gas industry that is set out in section 2.4.



In order to answer the research question, a case study approach will be followed<sup>7</sup>. Through a case study, a detailed picture can be formed of the political risk that a Chinese oil corporation may face in an African country, which can provide a basis for identifying the main indicators of political risk. One of China's large NOCs, CNPC, is the largest oil investor in South Sudan, a new country where the political environment has changed since the country seceded from Sudan on 9 July 2011. To both supplement and support the main research question the following two sub-questions were identified:

- What are the features of the relationship between China and Sudan before South Sudan's independence?
- What is the level of political risk that CNPC faces in South Sudan since the country's independence on 9 July 2011?

### **1.3 Objectives, rationale and significance of the study**

Chinese oil corporations are expanding their investments in African countries, and often in countries where the political environment exposes the firms to high risk. For these firms the analysis of political risk, as part of investment risk, is of key relevance to the success of their business operations in Africa. Risk assessments assist the investor in weighing up the opportunities of high returns against potential losses (Brink, 2004:148). Political risk analysis is grounded in problem-solving and decision-making theory, "generally assumed to be a theory underlying rational decision-making under uncertainty" (Brink, 2004:30). For Venter (1999:1), the principle of reasoned and defensible decision-making is that a "decision-maker should anticipate future events, decide what measure of control is possible over those events and make a choice from those events that will produce a preferred outcome." The analysis of political risk is a tool that investors can use to make reasoned and defensible decisions regarding investments (Venter, 1999:1). By conducting political risk analyses, investors can reduce uncertainties about the future and will be in a better position to make rational choices about their operations in the foreign country. A clear understanding of all factors and its indicators that can have an influence on political risk is necessary to conduct a reliable and purposeful political risk analysis. By gaining a better understanding of the relationship between international firms and politics and the implications of the relationship for political risk, investors can better prepare themselves to deal with these risks in the decision-making process.

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<sup>7</sup> For detail on the methodology followed refer to section 1.4.

The political environment of the African countries is often negatively associated with high levels of political risk. However, if firms only focus on macro political risks in the African country and do not take the specific impact for the firm into account, it is possible that the firm may miss profitable business opportunities. Frynas and Mellahi (2003:563) found “political risk to be highly firm-specific and a potential source of competitive advantage”, because firms have specific resources and capabilities to allow them to play an active role in shaping their environment. Therefore it is important to provide firm-specific political risk analysis when an analyst has to forecast political risk as a justification for a firm’s business decisions. This forecasting can be done by “logically following an analysis of the identified variables in a risk model, determining their relationship and establishing their influence on a certain situation” (Hough, 2008:7). In this way, it is not only the negative implications of risks that are highlighted, but the opportunities can also be identified where “risk can result in gains, even if there is a probability of losses” (Van der Lugt & Hamblin, 2011:25). Van der Lugt and Hamblin (2011:25) argue that Chinese firms operating in Africa have this perspective of risk that can result in gains, and the idea of opportunities as the positive side of risk is “expressed in the Chinese character for ‘crisis’, which contains both the word ‘chaos’ and opportunity’.” The objective of the study is to illustrate the importance of firm-specific political risk analysis for Chinese firms operating in the oil and gas industry in Africa by way of a case study of CNPC in South Sudan, an African country that is perceived to have an unstable political environment. The aim of the study is not to develop a new model for political risk analysis, but rather to identify the main indicators of political risk that Chinese firms operating in the African oil and gas industry may face and to measure the level of political risk that CNPC faces in South Sudan. The rationale behind the study is to gain a better understanding of the nature of political risk faced by Chinese corporations in the African oil and gas industry. This may provide valuable information for analysts to improve political risk assessments that can serve as a basis for decision-making by Chinese corporations.

The significance of the study is that by empirical research on political risk more knowledge and understanding will be gained on political risk factors and its indicators. In particular, the study will contribute to a better explanation of the relationship between business and politics in the oil and gas industry. Contributions to the field of political risk and political risk analysis are important, as the nature of political risk is changing and becoming increasingly complex and multidimensional (Jakobsen (2011:482). As Brink (2004:410) comments, “the rationale behind political risk analysis remains the fact that political dynamics and ever-changing business climates constantly influence and change investment opportunities and profitability”. For Boshoff (2010:96) the field of political risk can be seen as a bridge between politics and

business and a better understanding of the character of political risk can help political risk analysts to provide better risk assessments on which business decisions can be based. In particular, if micro political risks are better understood, the analysis of political risk can provide a better forecast of future political events and the impact of the events on particular international firms. With better tools to use as a basis for reasoned decision-making, investors should be able to manage risks or mitigate the effects and take advantage of opportunities in order to maximise the firm's profitability or other strategic goals.

#### **1.4 Research design and methodology**

The study will follow a qualitative approach and the research design is an empirical case study. The case study will be carried out in the form of a political risk analysis for CNPC's investments in the South Sudanese oil industry. According to Yin (2009:18), a case study is defined as "an empirical inquiry that investigates a contemporary phenomenon in depth and within its real-life context, especially when the boundaries between phenomenon and contexts are not clearly evident". One case is selected to perform an analytical study to demonstrate a causal argument or a theory (Neuman, 2006:40). Neuman (2006:159) explains that a wide variety of aspects of the same case are examined in the case study in order to find explanations or interpretations. A case study approach will be followed in this study because the phenomenon of political risk and the relationship between politics and business requires an in-depth understanding of the context of the real-life situation. Kobrin (1979:78) remarks that a case study can give in-depth knowledge about the relationships that influence political risk and the nature of the impact of political risk events. The theories of political risk, in particular micro political risk, will be demonstrated by way of empirical enquiry in the form of a political risk analysis. According to Yin (2009:9-11), case studies can be performed as a research method when contemporary events rather than historical events are investigated and when the research requires explanations. This study warrants a case study approach because the research focuses on current events, i.e. events since the recent secession of South Sudan from Sudan, although the historical context is necessary in order to understand the contemporary situation. Furthermore, the research questions, as set out in section 1.2, require explanations. The case study is a "distinctive form of empirical enquiry" and can therefore not be generalised to populations or universes, but is rather generalised to theoretical propositions with the goal of expanding or contributing to general theories (Yin, 2009:14,15). This study will contribute to the general theories of political risk and political risk analysis by way of empirical research.

The case study will focus on the political risk faced by CNPC in South Sudan. CNPC was selected as a firm for the case study because it is an oil corporation and unique in the sense that it

is a Chinese state-owned enterprise (SOE) which only started to integrate into the world economy since the 1990s. The reason that South Sudan was selected for the case study is firstly because of the change in the region's political environment since the South Sudanese secession from Sudan on 9 July 2011. Secondly, the oil industry plays a major role in the country's economy. Thirdly, the investment by CNPC in Sudan, of which a major part was transferred to South Sudan after its secession, was CNPC's first major investment abroad. Fourthly, CNPC holds the majority of the shares in the two largest operating consortiums in the country.

A main research question and two sub-questions that will guide the study were identified in section 1.2. The first sub-question that asks what the features of the relationship are between China and Sudan before South Sudan's independence will be answered in Chapter Three through descriptive research. The answer to this sub-question will provide the context that is necessary as a background to answer the second sub-question, which asks what the level of political risk is that CNPC faces in South Sudan since the country's independence. The second sub-question will be answered in Chapter Four by way of a political risk analysis. The answers to these two sub-questions will support the main research question that asks what the main indicators of political risk are that Chinese corporations may face in the oil and gas industry in African countries. By examining the content and the risk ratings of the political risk factors and indicators of the political risk analysis, the main indicators of political risk that Chinese corporations may face will be identified and presented in Chapter Five.

The purpose of the research is descriptive as well as explanatory. According to Neuman (2006:34-35), descriptive research presents a detailed picture of the situation or the social setting of the subject being studied. In this study, the contextualisation of the Chinese FDI in the South Sudanese oil industry will be descriptive research. The purpose of the political risk analysis is explanatory, as the analysis will explain why certain factors and indicators identified in the study will contribute to higher or lower political risk levels. As Neuman (2006:35) explains, explanatory research builds on descriptive research to identify the links between events or the reasons why events happened, usually in accordance with theory to determine the best explanations. Because micro political risk affects a specific firm or industry, Alon and Herbert (2009:127) note that the unit of analysis is not only the host country, but also the firm's nationality, industry, particular characteristics of the project and the relationship between the host country and the firm. The unit of analysis of this study is therefore the oil and gas industry in South Sudan as well as CNPC and its relationship with the governments of China and South Sudan. The time dimension of the study is cross-sectional as the oil and gas industry of South Sudan will be analysed since the date of independence of 9 July 2011 until 31 August 2012. However, the history of the oil industry and its connection to the politics of Sudan and South

Sudan is essential in understanding the political risk that CNPC faces in South Sudan. Therefore, historical information applicable over a longer period of time will be gathered and interpreted in order to get a better understanding of the current level of political risk.

As a theoretical background to the study, theories on political risk and political risk analysis will be examined. The theoretical framework of political risk and political risk analysis is grounded in rational decision-making theory, because political risk assessments can help investors to anticipate future events on which reasoned and defensible investment decisions can be based (Venter, 1999:1). As a framework for the political risk analysis, Alon et al. (2006:624) argue that it is important to use an industry-specific model because micro political risks differ from industry to industry. As the aim of the study is not to develop a new political risk model, an existing model, a model developed by Boshoff (2010), will be used as a basis for performing the analysis. There are various political risk models that are used in the industry of political risk assessment, but many are not readily available as they are considered intellectual property of those companies that developed them. By conducting research on elements of these models as reconstructed by various scholars, Boshoff (2010) developed a political risk analysis model for the oil and gas industry that follows a mixed methods approach, incorporating quantitative and qualitative methods. The model is compact and based on a simple mathematical calculation, but at the same time also comprehensive in the sense that macro and micro political risk indicators are incorporated into one model. This makes the model valuable for the purposes of this study, as another model developed by Alon and Herbert (2009) that was also considered, only assesses micro political risk. It is important for the purpose of this study to include the measurement of both macro and micro political risk to establish what the main indicators of political risk for Chinese oil corporations are. Boshoff's (2010) model incorporates six political risk factors, i.e. political, economic, societal, petroleum, company and international factors that are analysed and rated in accordance with different indicators.

The study will make use of textual secondary data such as academic articles, books and credible internet sources as the basis for the analysis. As Neuman (2006:41) states, most case studies are qualitative in nature that follow a nonlinear path and the context of the case is researched and interpreted. This research is oriented at interpretation by way of an analysis of the qualitative data where motives, themes and ideas rather than variables will be studied. Because of the qualitative nature of the data, Neuman (2006:151-152) emphasises that the credibility and validity of the evidence is very important. This study will therefore use a variety of sources, and their credibility will be checked.

## **1.5 Literature overview**

Three broad fields of literature will be consulted in the research. Firstly, literature on political risk and political risk analysis will be examined to provide a theoretical background to the study. To conceptualise political risk and political risk analysis, the main texts that will be used are Brink's (2004) *Measuring political risk: risks to foreign investment* and articles by Robock (1971), Kobrin (1978 and 1979), Simon (1982 and 1984), Fitzpatrick (1983), Bremmer and Keat (2009), Howell and Chaddick (1994) and Frei and Ruloff (1988). Studies by Alon et al. (2006), Alon and Herbert (2009), Boshoff (2010) and Frynas and Mellahi (2003) will be of particular importance as they provide a better understanding of micro political risk, i.e. industry-specific and firm-specific political risk, that will be the focus of this study.

A second group of literature will provide the information on Chinese foreign policy and Chinese business operations in Africa, which is needed to contextualise the Chinese NOCs and their relations with the Chinese government. While Liou's (2009) article *Bureaucratic politics and overseas investment by Chinese state-owned oil companies: illusory champions* and Van der Lugt and Hamblin's (2011) *Assessing China's role in foreign direct investments in Southern Africa* give insight into the strategies and institutions involved in Chinese FDI, Jiang's (2009) *Fuelling the dragon: China's rise and its energy and resources extraction in Africa* and Corkin's (2011) *Redefining foreign policy impulses toward Africa: the roles of the MFA<sup>8</sup>, the MOFCOM and China Exim Bank* are important as a background to Chinese investments in Africa and the relationship between Beijing, the NOCs and the African countries. Other literature that will be consulted includes articles by Kolstad and Wigg (2009), Rui (2010), Cissé (2012) and Holslag (2011).

The third field of literature will cover the history of Chinese involvement in the Sudanese oil industry, a background to the Sudanese civil war and the political situation in South Sudan after its secession from Sudan, with specific reference to CNPC and China's current relations with South Sudan. In this regard, a valuable document is ICG's (2012a) *China's new courtship in South Sudan*. Other recent publications that are all based on interviews done in South Sudan during 2012, are Kuo's (2012) *Not looking to lead: Beijing's view of the crisis between the two Sudan's*, Wheeler's (2012) *Development through peace: could China's economic cooperation with South Sudan be more conflict-sensitive?* and Barber and Xiao's (2012) *Win-win? China's economic engagement with South Sudan*. Lacher's (2012) *South Sudan: international state-building and its limits* provides valuable information on current developments in South Sudan. Various recent publications by Business Monitor International (BMI) will be consulted with specific reference to the economic situation in South Sudan.

## **1.6 Limitations and delimitations of the study**

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<sup>8</sup> MFA is the acronym for Ministry of Foreign Affairs.



One of the limitations to the study is the definition of the term political risk, as there is no consensus among scholars in the field (Alon et al., 2006:624). To overcome this limitation, theoretical research will be performed in order to conceptualise political risk and political risk analysis for the purposes of this study. As Brink (2004:2) points out, the possible subjectivity of a political risk analysis is a further limitation, as with other qualitative research studies. In an attempt to reduce subjectivity, the analysis will be performed in accordance with a political risk model that includes quantitative methods. With regards to the case study, a limitation might be the availability and access to sources for an accurate description and analysis of the Chinese NOCs and the current South Sudanese situation. As inside knowledge of the Chinese NOCs is only available in secondary journals, it is possible that not all relevant information will be available. Language might also be a barrier and only English texts will be considered. Although many of the works of Chinese scholars are written in English, it is possible that important texts from different perspectives may not be available in English, that in turn may influence objectivity. Although a firm-specific risk analysis will be performed, the lack of knowledge of the specific criteria that Chinese corporations would consider in a political risk analysis may be a further limitation. However, the objective of the study is not to advise a certain client on an investment, but rather to gain more knowledge about the political risk factors and its indicators that Chinese firms may be exposed to in the African oil and gas industry.

As the political situation in South Sudan is volatile and political risk can change over time, the political risk analysis for CNPC will be based on data collected up to 31 August 2012. While one of the aims of political risk analyses is to suggest ways for investors to mitigate and manage the risks, risk mitigation and risk management advice falls outside the scope of this study.

## **1.7 Outline of the study**

Chapter Two will present a theoretical framework for the study and conceptualise key terminology that will be used during the course of the study. The terms that are conceptualised are FDI, risk, political risk, country risk, political instability, macro and micro political risk and political risk analysis. Boshoff's (2010) political risk model, which will be used as an analytical framework for the political risk analysis will be presented in this chapter.

The purpose of Chapter Three is to contextualise the situation in which CNPC currently operates in South Sudan to serve as a background for the analysis of political risk. The first sub-question that concerns the features of the relationship between China and Sudan before South Sudan's independence will be answered in this chapter. The relations between Chinese NOCs and Beijing will firstly be put into context by describing the influence of Chinese foreign policy on

Chinese FDI in general, and then in Africa, followed by the FDI of Chinese NOCs in the African oil and gas industry. The next section will focus on China's role in the development of the Sudanese oil industry, followed by a brief analysis of the effect of the oil development on the Sudanese civil war. The last section of the chapter will describe the main issues concerning the independence of South Sudan on 9 July 2011.

In Chapter Four, the political risk faced by CNPC's current investments in South Sudan since independence will be analysed in accordance with Boshoff's (2010) political risk model in order to answer the second sub-question. Each risk factor and risk indicator identified in the model will be analysed, assessed and rated. A final calculation and explanation of the overall political risk will be presented.

Chapter Five will conclude on the research by an outline of the progress and an evaluation of the study. The answer to the main research question, recommendations for future research and a final conclusion will be presented.

## **1.8 Conclusion**

This chapter provided an introduction to the study by stating the research problem and research questions, the objective of the study and the research methodology. The aim of the study is to identify the main indicators of political risk that Chinese corporations may face in the oil and gas industry in African countries and to measure the level of political risk faced by CNPC in South Sudan. The objective of the study is to gain an understanding of the nature of political risk in the contemporary political environment of the African oil and gas industry and in particular the influence of the risk on Chinese firms. The objective is further to support the theories of political risk by way of empirical research, in particular to demonstrate the importance of firm-specific political risk analysis as a decision-making tool for investors. By gaining a better understanding of the relationship between international firms and politics and the implications for political risk, investors can better prepare themselves to deal with these risks in the decision-making process. The research will take the form of an empirical case study on the political risk faced by CNPC in the South Sudanese oil industry. Before starting with the case study, the next chapter will provide a theoretical grounding for the study, a conceptualisation of the key terminology used and a presentation of the political risk model that will be applied in the political risk analysis in Chapter Four.



## **Chapter Two: Theoretical perspective and conceptualisation of key terminology**

### **2.1 Introduction**

Politics has always been inseparable from international business markets, making the assessment of the political context of international business risk essential in the investment decision-making process. However, with the influence of new political actors other than governments and subtler and less extreme political actions than the expropriations of the previous century, political risk today is a “highly complex and multidimensional phenomenon” (Jakobsen, 2010:482,488). Bremmer (2005:52) argues that political risk has been influenced by the increased interconnectedness of the international markets as emerging markets today form a great part of the global economic activities. With increased worldwide energy demand, political instability in oil-producing countries can quickly produce oil price shocks and short supply all over the world (Bremmer, 2005:52). Furthermore, business operations have moved to countries where labour is relatively cheap but living conditions are harsh, posing new threats of civil and labour uprisings to business operations (Bremmer, 2005:52). Bremmer (2005:52) points out that the attack on the World Trade Centre in New York in 2001 has changed the global security landscape and foreign policy agenda, emphasising the risk posed by non-state actors such as terrorist networks (Bremmer, 2005:52). The global financial crisis of 2007-2008 and the subsequent downgrading of sovereign risk ratings, followed by the sovereign debt crises of developed countries, have further emphasised the effect that political decisions had on the economy and business operations (Gupta, 2011).

Because international business firms today operate in this increasingly risky environment caused by economic integration, globalisation and the influence of non-state political actors, the analysis of political risks became a necessity for the international business firm as a decision-making tool. It is therefore important to understand the multidimensional and changing nature of political risk in order to provide theoretically grounded political risk analyses. This chapter will firstly outline the theoretical basis of decision-making and problem-solving theory in which political risk analysis is grounded. Secondly, the chapter will conceptualise the key terminology associated with political risk and political risk analysis to provide an in-depth understanding of the meaning of the terms used in the context of this study. The last section of this chapter will present the political risk analysis model that will be applied in the case study in Chapter Four.

## 2.2 Theoretical grounding: decision-making and problem-solving theory

Political risk analysis is grounded in decision-making and problem-solving theory. These two theories have a complementary relationship in the application of management science, as management problems that have to be solved relate to the decision-making environment (Brink, 2004:31). Managers are concerned with problem-solving activities that involve “agenda setting, setting goals and designing actions” as well as decision-making activities such as evaluating and choosing among alternative actions (Simon, Dantzig, Hogardt, Plott, Raiffa, Schelling, Shepsle, Thaler, Tversky & Winter, 1987:11).

Rational decision-making theory is based on the principle that a decision-maker who is faced with a certain problem will make choices on the basis of the best or preferred outcome of the action taken (Simon, 1965:178). The decision-maker has to consider alternative actions or choices and for each action or choice determine the possible outcome, consequence or future affairs in order to justify the decision (Simon, 1955:102). Because the decision-maker is faced with uncertainties, information is needed to seek out the alternatives and calculate the consequences as well as the probability of the outcome if the specific decision is taken (Simon, 1979:511; Simon, 1955:102). For Venter (1999:1), reasoned decision-making is a cognitive or knowledge problem implying that before a decision can be made, it must be justified, not only by knowledge, but also by reason. Knowledge and reason are used to anticipate future events and the decision-maker can then respond to the possible outcome or adapt to the environment by choosing between alternatives (Venter, 1999:1). Simon (1979:502) points out that rationality is limited when all the relevant information is not available for managers to make reasoned decisions and a manager should search for alternatives. Consequently, it became necessary in management sciences to develop decision-making procedures that could be applied in practical situations (Simon, 1979:503). Decision-making theory can therefore be applied for the purpose of offering direct advice to business decision-makers and decision tools should be able to provide recommendations based on information from the real-life situation (Simon, 1979:498). Rather than being concerned with the outcome of the decision, decision-making theory is concerned with the way in which decisions are made (Simon, 1979:498).

Political risk analysis is based on the same principles as problem-solving and decision-making theory. March and Shapira (1987:1404) argue that the “idea of risk is embedded in the larger idea of choice as affected by the expected return of an alternative”. In the business environment, one of the problems that managers have to deal with is investment risk, including political risk. Apart from problem-solving, managers also have to make rational choices about what actions to take that would minimise the political risk and that would have the preferred outcome for the business, which is the survival as a profitable business (Venter, 1999:2).

Decision-making theory assumes that decision-makers would make choices based on the largest expected return (March & Shapira, 1987:1404).

As part of the management process of an international firm, political risk can be managed, and Venter (1999:1) suggests that it should be done in such a way that the choices that are made are justified on the basis of knowledge and reason. By conducting a political risk analysis, information and knowledge are gained and reason is used in the analysis thereof. Political risk analysis can be an analytical tool, but also a practical guide to decision-making for managers (Sethi & Luther, 1986:58). Political risk analysis allows political risk problems or factors to be identified, to anticipate future events and to determine the effect that the events will have on the business in terms of profitability or other goals (Venter, 1999:9). Potential actions can then be identified and management can make decisions and select the best course of action to minimise the negative effects on the business, weighing up the costs and the benefits (Brink, 2004:31; Howell & Chaddick, 1994:70). Actions can be drastic such as avoiding or withdrawing investments in certain countries or industries, but actions can also be to negotiate with the different actors to guard against risk. High risk might also produce new opportunities where other investors might have left, as high risk may mean high returns (Howell & Chaddick, 1994:70).

## **2.3 Conceptualisation of key terminology**

### **2.3.1 Foreign direct investment**

With globalisation and the integration of markets, FDI became an important way of internationalising a business (Graham & Spaulding, 2004). The term FDI as defined by the International Monetary Fund (IMF) and the Organisation for Economic Cooperation and Development (OECD) will be used in this study. FDI is defined as:

“a category of international investment made by a resident entity in one economy (direct investor) with the objective of establishing a lasting interest in an enterprise resident in an economy other than that of the investor (direct investment enterprise). ‘Lasting interest’ implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the direct investor on the management of the direct investment enterprise. Direct investment involves both the initial transaction between the two entities and all subsequent capital transactions between them and among affiliated enterprises, both incorporated and unincorporated” (OECD, 2012).

A further requirement is that the investor must hold at least ten percent of the ordinary shares or voting stock of the enterprise for a FDI relationship to exist (OECD, 2012). FDI should be distinguished from portfolio investment, which is considered an indirect investment (Graham &

Spaulding, 2004). While FDI outflow refers to the amount of FDI leaving a continent, region or country to invest in another country, FDI inflow refers to the amount of FDI entering a continent, region or country (Van der Lugt & Hamblin, 2011:18). A distinction should be made between greenfield and brownfield FDI. While greenfield FDI refers to “a form of FDI where a parent company starts a new venture in a foreign country, constructing new operational facilities from the ground up”, brownfield FDI refers to a direct investment where the international firm buys a share in an already existing facility in another country (Van der Lugt & Hamblin, 2011:19).

### **2.3.2 Risk**

According to March and Shapira (1987:1404), the term risk in classical decision theory reflects “variation in the distribution of possible outcomes, their likelihoods and their subjective values”. For Hough (2008:1), risk is associated with uncertainty about an event or action and the impact of that event or action. Shubik (1983, cited in Frynas & Mellahi, 2003:546), comments that one cannot refer to risk independently from purpose, and risk should therefore be defined in terms of a specific goal. Friedman and Kim (1988:64) further add that risk cannot exist independently from an entity. Although there are variations in the definition of risk in the literature, one can conclude that the major components of risk are:

- that risk should always be seen in relation to an entity and to a goal
- that risk is about the likelihood or probability that an event or action might occur
- and that risk is about the impact or outcome of that event on the goal of the entity.

The term risk in this study is used in the context of business risk, where a business refers to activities such as investments, business operations, donor activities, loans, joint ventures or agents. Because investors or lenders expect a return on their investments, and managers or employees expect business operations to continue, the main goal of a business is profitability as a measure of a business’s performance (Van Wyk, 2010:112). However, businesses also have other goals such as strategic value, job and physical security of personnel, infrastructure security and the long-term survival of the business (Bremmer & Keat, 2009:11). For the purpose of this study, risk will refer to:

the probability that an event or action might have an impact on the business firm’s expected performance in terms of the realisation of its main goals such as profitability.

Although risk is associated with uncertainty, a distinction should be made between uncertainty and risk. Uncertainty refers to a lack of information about the event and its impact (Brink, 2004:20). Because of the lack of information, it is difficult to establish the probability and the

outcome of events in uncertain conditions, and a business will find it hard to control these events (Van Wyk, 2010:110). Risk on the other hand, according to Friedman and Kim (1988:64), is not about the lack of information, but rather about the probability that an event might happen and cause a loss to the firm. An uncertainty will become a risk when the probability and the outcome of the event can be established by information on the circumstances (Fitzpatrick, 1983:25). Allan Willet (1951, cited in Bauzon, 2000:27) makes the distinction by referring to risk as “objective doubt” and uncertainty as “subjective doubt” about the outcome. For Willet (1951, cited in Bauzon, 2000:27), risk should be defined with reference to the “degree of uncertainty about the occurrence of a loss”. With information about the business environment, these uncertainties can be converted into measurable and manageable risk (Kobrin, 1979:68). It is possible to determine the levels of risk by estimating or forecasting the probability of an event or action and the possible material outcome (Hough, 2008:3). However, even when risk is measured, Bremmer and Keat (2009:24) remark that there will always be a certain level of uncertainty because of the difficulties in risk measurement.

Bremmer and Keat (2009:4) emphasise the importance of the other component of risk, i.e. the impact on the business if the event does occur. For them the biggest risks are those events that are perceived as unlikely to happen and are difficult to predict with scientific methods, but if they do happen, their impact is “catastrophically damaging” (Bremmer & Keat, 2009:4). Taleb (cited in Bremmer & Keat, 2009:18) calls these events “black swans”<sup>9</sup> and argues that major events in the world such as World War I and the September 11 attacks on the World Trade Centre in 2001 have been outliers and came as a surprise, and the impact was disproportionately high to the probability of it. Bremmer and Keat (2009:4) refer to these “black swans” as “fat tails”, meaning by that the unexpectedly thick bulges or “tails” at the end of distribution curves that measure risks and their impact (Bremmer & Keat, 2009:4). Bremmer and Keat (2009:4) argue that although these events are perceived as unlikely to happen, history shows that these events actually happen more often than people think. It is for this reason that they emphasise the need not to ignore the collective impact of smaller events (Bremmer & Keat, 2009:20). For example, the impact of corruption over several years can have a major influence on a country’s political stability, that in turn can have a huge impact on businesses operating in that country (Bremmer & Keat, 2009:20). However, it should be remembered that although risk normally has a negative connotation, high risk also implies that there are opportunities for high profits (Van der Lugt & Hamblin, 2011:25). For example, oil shocks have a negative implication for oil importing

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<sup>9</sup> The “black swan” refers to the unpredictability of events such as the discovery that swans could also be black when European explorers, who considered swans always to be white, first found black swans in Australia (Bremmer & Keat, 2009:19).

countries, but for oil corporations, high oil prices mean opportunities for high profits. Risks, unlike uncertainty, can be managed and mitigated or be exploited to increase the return on the investment (Brink, 2004:21). The impact of risk can therefore relate to both losses and gains (Bauzon, 2000:27).

### **2.3.3 Political risk**

Political risk as a type of business risk is generally associated with the influence of politics on the international business firm. A variety of definitions for political risk exist in the literature and an overview of the concept is necessary to conceptualise the term for the purpose of this study.

For Robock (1971:7), “political risk in international business exists (1) when discontinuities occur in the business environment, (2) when they are difficult to anticipate and (3) when they result from political change”. Further, the political change must have the potential to affect the profit or other goals of a firm. Like Robock (1971), Kobrin (1979:77) emphasises political change and the impact of the political change on the returns of a project, by his operational definition of political risk as the “probability that changes in the political environment will reduce returns to the point where the project would be no longer acceptable on the basis of *ex ante* criteria”. Howell and Chaddick (1994:1) include the social dimension of the political environment and more directly refer to the negative impact on profits with their conceptualisation of political risk as “the possibility that political decision, events or conditions in a country, including those that might be referred to as social, will affect the business environment such that investors will lose money or have a reduced profit margin”. Ekpenyong and Umoren (2010:28) recognise the multidimensionality of political risk by a broad definition, conceptualising political risk as “any politically induced event that has destabilising effects on the polity and distorts the functionality of an enterprise”. Simon (1982: 68) also recognises the multidimensionality, but gives a much more detailed definition of the different dimensions. Simon (1982:68) linked political risk to different sources and specifically to the foreign business by his definition of political risk as “governmental and societal actions and policies, originating either within or outside the host country, and negatively affecting either a select group of, or the majority of foreign business operations and investments”. With this definition, the distinction is made between macro and micro political risk, where macro political risk refers to risks that affect the majority of foreign operations and investments in a host country or region and micro political risk is discriminative in the sense that only a select group is affected.

It is therefore clear that there are many definitions in the literature on political risk. To conceptualise political risk for the purposes of this study, certain essential attributes of political

risk have been identified during the review of the literature that should be included in a definition of the concept as it will be used in the study.

Firstly, this study will be concerned with international business firms that operate or intend to operate in foreign countries and the political risk that these firms are exposed to. Boddewyn and Brewer (1994:125) point out that the influence of politics is different for domestic and international firms mainly because of the multiple sovereign states and government controls that have to be dealt with by international businesses. International businesses further have more strategic options when they operate in foreign countries, and foreign firms can influence the actions of governments by “arbitrage and leverage options” that domestic firms do not have (Boddewyn & Brewer, 1994:126).

The second attribute that should be taken into account is the point that Fitzpatrick (1983:251) makes that political risk is a process rather than a sudden event. This view is shared by Robock (1971:11), who argues that risk is not static and can change over time, as well as Sethi and Luther (1986:62), who refer to political risk as a “gradual event such as ideological changes”. Van Wyk (2010:115) also refers to “risk development”, and thereby implying a process.

The third attribute of political risk is its multidimensionality. Brink (2004:25) emphasises the interrelationship of factors that can affect the business and investment climates, while Bremmer and Keat (2009:7) mention that one form of risk can create other forms of risk. For example, macro-economic trends is a factor that can influence political risk on the one hand, and on the other hand political decisions can have economic consequences that may impact business operations (Bremmer & Keat, 2009:9). Furthermore, Alon and Martin (1998:11) argue that the sources of political risk are not limited to the host country, but also imply factors that originate from the home country environment, the international environment and the global environment. Jakobsen (2010:482) also adds the dimension of political actors other than governments, such as terrorists, activists, rebel groups or stakeholders as a source of political risk.

The last attribute of political risk refers to the impact of the political process or event. The impact is normally associated with profitability, but Robock’s (1971:7) reference to “discontinuities in the business environment” implies that firms can also have other goals that might be affected. Although most literature refers to political risk in the negative sense, Alon and Herbert (2009:130) argue that political risk is a neutral phenomenon. They point out that political risk can have positive and/or negative outcomes for different entities and therefore international firms should safeguard against negative risk factors, but should also identify and exploit politically based opportunities (Alon & Herbert, 2009:130). Kobrin (1979:67) makes the point that not all political events or conditions that have negative connotations for one firm will necessarily have negative consequences for all international businesses in all situations. Frynas



and Mellahi (2003:548) illustrate this by the example of the Nigerian civil war from 1967-1970 that disrupted the onshore oil production activities of foreign oil companies in Nigeria, but had a positive effect on oil companies that exploited the civil war by expanding their offshore oil production during the time of political instability<sup>10</sup>.

Because these four attributes, i.e. business firms, events from political processes, the multidimensionality of risk sources and the neutrality of the impact of risk, are incorporated in the definition of micro political risk that Alon and Herbert (2009:130)<sup>11</sup> present, their definition will be used as a basis for a final conceptualisation of political risk for the purposes of this study. This definition will be adapted in two ways. Firstly, the term “uncertainty” in Alon and Herbert’s (2009) definition will be substituted with the term “risk”<sup>12</sup>. Secondly the reference to “specific consequences for the firm” will be adapted to “general and specific consequences” to incorporate all political risk, i.e. macro and micro political risk. Therefore, the term political risk in this study refers to:

The risk<sup>13</sup> associated with outcomes or events from political processes, which have potential consequences, in general and specifically<sup>14</sup>, “for firms that are either contemplating entry into, or have already entered, another country. These political processes can result in outcomes or events which can emanate from environmental factors both within and outside the foreign host country, and either positively or negatively affect the firm’s operations, assets, or financial condition” (Alon & Herbert, 2009:130).

#### **2.3.4 Country risk**

Political risk should be distinguished from country risk, although some elements of the terms overlap. Brink (2004:19) defines country risk as the risk that an enterprise might incur “financial losses due to problems arising from macro-economic events in a country”, which is the definition that will be used in this study. For Frei and Ruloff (1988:3), country risk means the total risk that foreign investors have for investing in a country. It therefore seems as if country risk is a broader concept than political risk. For political risk the focus is on the political event or process as the cause of the losses to the investors, while for country risk the source of the risk can be more general in terms of the investment climate of that specific country.

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<sup>10</sup> The term political instability should be distinguished from political risk. For a conceptualisation of political instability see section 2.3.5.

<sup>11</sup> For the definition of micro political risk by Alon and Herbert (2009:130) refer to section 2.3.6.

<sup>12</sup> For an explanation of the difference between the terms risk and uncertainty as used in this research study, refer to section 2.3.2.

<sup>13</sup> Alon and Herbert (2009:130) use the term “uncertainty” in their definition.

<sup>14</sup> Alon and Herbert’s (2009:130) definition only refers to “specific consequences” because their definition only refers to micro political risk.



Country risk is often used in terms of a country's ability to pay its debt (Brink, 2004:22), but it seems as if the issue of creditworthiness is only part of the country risk. Frei and Ruloff (1988:3) describe sovereign risk as the risk that is associated with "granting loans to foreign governments". Sovereign risk is a part of country risk, with the focus on the risk that a government will not be able to pay or service its loans (Boshoff, 2010:17). In this sense, Brink (2004:23) makes the distinction between country risk and political risk where country risk implies the risk that a country will not be able to pay back its loans, and political risk implies that a country is able to pay back its loans, but is unwilling to do so. For example, a country might have balance of payments problems that would pose a country risk to its creditors, as the country would not be able to repay its debts. However, country risk can be a source of political risk when a government is forced to cut back on social spending to improve its balance of payments as part of a structural adjustment program (Brink, 2004:23). Budget restrictions such as a cut back in social spending or tax increases can cause civil unrest or social upheaval and in that sense country risk can become political risk. On the other hand, a government's decision not to accept the conditionalities imposed by structural adjustment programmes can also result in political risk to investors if the government defaults on its debt that would lead to economic instability, a source of risk to investors in a country in terms of elements such as currency volatility, poor market demand or bad debts (Brink, 2004:23).

### **2.3.5 Political instability**

Apart from country risk, political risk should also be distinguished from political instability, although the terms are sometimes used interchangeably. Political risk is broadly the risk associated with outcomes or events from political processes that have an impact on foreign business firms<sup>15</sup>. Political risk is therefore a property of the business and cannot exist on its own (Kobrin, 1978:114). Political instability on the other hand is observable and a property of the environment, or the status of the political situation in a country (Kobrin, 1978:114; Frynas & Mellahi, 2003:545). Political instability refers to changes in the political leadership or government policy that was not foreseen or expected (Brink, 2004:19). Although the term political instability has a negative connotation and is normally associated with high political risk, Kobrin (1978:120) argues that the negative view of political risk is a result of cultural subjectivity. Robock (1971:16) agrees that many enterprises perceive political instability as high risk because they analyse the political conditions of another country from an ethnocentric point of view. He uses the example of the frequent changes of government in France before the time of De Gaulle, that might be perceived as political instability, while the stabilising role of a strong

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<sup>15</sup> For a detailed definition of political risk see section 2.3.3.

bureaucracy are ignored. Kobrin (1978:114) gives the example of a coup that might not be violent or lead to a change in government policy. Political instability therefore does not necessarily lead to high political risk. On the other hand, the argument can also be made that a stable political regime will not necessarily pose low political risk to enterprises. Bremmer and Keat (2009:29) argue that the stable regime in Venezuela under Hugo Chavez instituted government policy that had direct negative impacts for the investors in the oil industry. Chavez's stable regime contributed to high political risk. It is thus clear that there might be a relation between the two concepts of political instability and political risk, but it is not a necessary one.

Political instability is a political factor or event that might have an impact on the political risk exposure of a firm, but it is not the only factor or source, or necessarily the most relevant source of political risk to be considered (Brewer, 1981:6). Furthermore, political instability does not necessarily lead to political risk, because it might not affect the specific firm (Robock, 1971:16). In situations of political instability, it is important to assess the impact that the political instability might have on the firm operating in the specific country in order to identify it as a source of political risk.

### **2.3.6 Macro and micro political risk**

As mentioned in the conceptualisation of political risk in section 2.3.3, political risk has a macro and a micro risk dimension. For Robock (1971:9), "risk is of a macro nature when unanticipated and politically motivated environmental changes are broadly directed at all foreign enterprise", while Alon and Martin (1998:10) define macro political risk as the risk that "represent the systematic portion of the political risk analysis that can be generalised across industries." Macro political risk therefore refers to the dimension of political risk that will affect all foreign firms and all industries operating in the host country or in a certain geographic region (Alon & Herbert, 2009:127). The effect of these risks can be dramatic, for example when a government is overthrown or when the country's economic system is revolutionised (Alon & Herbert, 2009:129). Robock (1971:9) uses the example of the confiscation of private enterprise during 1959-1960 in Cuba as part of the move to a socialist system brought about by the Cuban revolution.

While macro political risk affects all or most of the foreign firms operating in a country or region, micro political risk is firm-specific, meaning that it affects only a single firm or a select group of firms or business activities (Alon & Herbert, 2009:129). Robock's (1971:9) definition states that "risk is of a micro nature when the environmental changes are intended to affect only selected fields of business activity or foreign enterprises with specific characteristics". What is important in terms of micro political risk, is that the influence on the firm is discriminative

towards certain firms. Alon and Herbert's (2009:130) definition of micro political risk is used in this study, with the only adaptation that the term "risk" will be used in the place of their term "uncertainty". Micro political risk is defined as:

The risk<sup>16</sup> associated with "outcomes or events from political processes, which have potential and specific consequences for the firm that is either contemplating entry into, or has already entered, another country. These political processes can result in outcomes or event which can emanate from environmental factors both within and outside the foreign host country, and either positively or negatively affect the firm's operations, assets, or financial condition" (Alon & Herbert, 2009:130).

Micro political risk refers to the specific risks for firms, either because of the industry in which the firm operates or because of other characteristics attached to specific firms. Risks can vary for different industries. While industries of strategic importance such as natural resources and banking are more likely to be regulated, the political environment in the host country can influence industries in different ways (Alon & Herbert, 2009:129). Alon et al. (2006:625) give the example of potential war that would have a major influence on an oil-producing company, while the balance of payments situation in a country would have a major impact on risk for the banking industry. Frynas and Mellahi (2003:541) argue that within the same industry different firms that are exposed to the same political event or environment can be affected differently because of the specific firm's characteristics, such as its strategic capabilities and resources. Alon and Herbert (2009:129) make the point that micro political risk is not independent from macro political risk as micro risk also originates from internal and external as well as economic, societal and governmental forces, but that some firms are more likely to be affected by certain macro political risks. Therefore, political risk assessment should incorporate both macro and micro political risk factors (Alon & Herbert, 2009:128).

Alon and Herbert (2009:130) identify specific aspects of international firms that can contribute to a differentiated impact on political risk, such as a firm's contribution to the economy, its bargaining power, its behaviour and its governance structure. For Frynas and Mellahi (2003:541), the impact of political risk events varies for different firms because firms are not just "passive bystanders" of the political environment, but are "actors capable of acquiring and upgrading firm-specific resources and capabilities for coping with or even benefiting from political risk". Frynas and Mellahi (2003) draw on Boddewyn and Brewer's (1994:123,127) argument that there is a reciprocal relationship between the political behaviour of international

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<sup>16</sup> The definition by Alon and Herbert (2009:130) of micro political risk use the term "uncertainty" where this study will refer to "risk", because the term uncertainty is differentiated from the term risk. For a detailed discussion of the differences between uncertainty and risk see section 2.3.2.

firms and firm, industry and nonmarket environment factors. While the political behaviour influences these factors on the one hand, the factors may influence the political behaviour on the other hand. For Boddewyn and Brewer (1994:128) a firm's political behaviour can include, amongst others, dealings with government officials to obtain permission to trade, compliance to the rules of the government, the avoidance of the rules by leaving the country, and partnership formation with government (Boddewyn & Brewer, 1994:128,130). Keillor, Wilkinson and Owens (2005:629) also include lobbying, industry alliances and contributions to the government as political behaviour of international firms. An international firm's bargaining power with the government of the host country is therefore important to secure a competitive advantage for the firm against rivals and to secure against other political risks (Boddewyn & Brewer, 1994:128,130). For Frynas and Mellahi (2003:562) the competitive advantage of international firms can include political influence in the host country, experience in dealing with corrupt officials, specific technical expertise or the ability to appease the local population of the host country. By exploiting the competitive advantage and by using its resources, firms can play an active role in confronting or shaping the political environment or political events in order to reduce the political risk for the specific firm. Frynas and Mellahi (2003:543) give the example of an extreme case where ITT, an America company, used its capabilities to put pressure on the United States (US) government to help stop the 1970 election of the Chilean president, Salvador Allende. However, Jakobsen (2010:483) warns that the political behaviour of the firm may increase political risk due to the "obsolescing bargain mechanism". By that is meant that a government may increase its leverage over the international firm once the firm has made large capital investments in the host country, making it difficult for the firm to withdraw without severe losses (Jakobsen, 2010:483). Because of a gradual shift in the relative bargaining power of the firm, there can be a gradual shift of government intervention in the affairs of the international firm (Jakobsen, 2010:483).

Another relevant factor that may differentiate firms is the relationship of the firm and the host country with the firm's home country, because the international firm is often associated with a particular nationality (Alon & Herbert, 2009:130). Because of the interdependence of international, home-country and host-country policies, political risk can also originate in the home country or a third country, for example by home country policies such as sanctions on countries that are regarded as "unfriendly" (Sethi & Luther, 1986:62). Furthermore, Gao (2009:107) argues that it is not only governments of the various countries that cause the political risk, but also other stakeholders such as labour unions, suppliers, competitors and non-governmental organisations (NGOs). For example, other stakeholders can lobby or press the government to take action against the international firm (Gao, 2009:107). The withdrawal of the

Canadian oil company, Talisman Energy, from Sudan in 2003 is a clear illustration of the interdependence of the policies and pressures of the different stakeholders that contributed to the specific political risk for Talisman. Kobrin (2004:428) argues that the political risks that forced Talisman to withdraw from Sudan originated in North America, reflecting the “complexity of the political environment” in which international firms operate. Activists linked Talisman to massive human rights violations during Sudan’s civil war and the Canadian government has been pressurised by the US government to investigate these allegations (Kobrin, 2004:453). The Canadian government responded to the US pressure because of the high degree of economic integration between the US and Canada. Also contributing to the complexity of the relationships is the fact that Talisman entered Sudan with a relative advantage because of the lack of US competition, as a result of the US sanctions against Sudan (Kobrin, 2004:455). It is therefore clear that there are multiple stakeholders from the host country, the home country and the international community that can contribute to increased micro political risks. On the other hand, the influence of the governments of the home countries can also reduce the political risk that firms are exposed to by international treaties, concessions and pacts that can safeguard against some aspects of risk, for example by pressure from the home government to withhold aid (Sethi & Luther, 1986:63). The relationship between the home country, the international business and the host country government can be used as a way of bargaining power, in conjunction with the bargaining and negotiating skills from the international business firm (Sethi & Luther, 1986:66). Frynas and Mellahi (2003:554) use the example of French oil firms that invested in oil blocks situated in disputed border areas between Nigeria and Cameroon as well as Nigeria and Equatorial Guinea during the 1990s, despite the political risk attached to the investments. They argued that the French oil companies could count on the economic and military support of the French government because of their close relationship (Frynas & Mellahi, 2003:554). Furthermore, because of the economic dependence of the African countries on the French government, France still had political connections to the elite in its former colonies, resulting in political influence. This gave the French oil firms a competitive advantage that could be exploited to their benefit (Frynas & Mellahi, 2003:554).

### **2.3.7 Political risk analysis**

The purpose of political risk analysis is to provide information on political risk for investors on which they can base decisions about their investments and business operations, and to manage the political risk in such a way that the negative effect on the business is mitigated. Although there are different methods of political risk analysis, Kobrin (1978:114) emphasises that such an analysis requires a systematic evaluation of political risk where possible political risk events are

identified and the probability as well as the consequences for the investor assessed. Furthermore, political risk analysis should be done on a regular basis as new information might lead to new forecasts (Hough, 2008:2). A distinction should be made between *predicting* and *forecasting* future political events that may affect the investor. While it is not possible to accurately predict political risk, political risk can be forecasted based on evidence such as scientific theories and empirical evidence that support the forecast (Brink, 2004:27). A forecast is the probability that a political event might cause losses for the investor in the future (Brink, 2004:27). Bremmer and Keat (2009:23) are of the opinion that through political risk analysis it is even possible to identify the risk of events that have a low probability of happening, but that would have a high impact on investors, like the 9/11 terrorist attacks in the US. However, Brink (2004:28) points out that even the most sophisticated forecasting models and sources of information have limitations and therefore it is not possible to have absolutely accurate forecasts. Although political risk events cannot be predicted, they can be forecasted on the basis of political risk analysis. The validity and the reliability of the forecast will depend on the quality of the political risk analysis that in turn is influenced by aspects such as the methodology and the quality of the data used. For political risk analysis to be valid and to gain scientific recognition, Simon (1984:124) argues that the procedures followed should be done in a systematic way using models that are reliable. There are many models available for political risk analysis, but methodological problems can be encountered as some models are quantitative and others are qualitative in nature. It is therefore important to consider the attributes of qualitative and quantitative methods of political risk analysis.

### ***2.3.7.1 Qualitative and quantitative political risk analysis***

The main advantage of a qualitative approach is that such an approach looks at the political situation and risk factors in context. A specific situation can be analysed in context and a problem-solving assessment can be applied. For example scenario analysis will help the business firm to work towards a specific solution to the specific problem that the firm faces (Bremmer & Keat, 2009:24). A wider range of information would be gathered on the specific situation that might not be included in a quantitative model (Frei & Ruloff, 1988:6). However, promoters of quantitative approaches argue that qualitative analysis could be too subjective (Brewer, 1981:9). On the other hand, Frei and Ruloff (1988:7,9) argue that subjectivity is also a limitation in quantitative methods, as quantitative methods are still based on assumptions and judgments made by analysts. For Brink (2004:21), the quantitative model has the advantage of providing a calculated result in numerical terms for political risk, and therefore it can be used effectively in the management of the political risk. Furthermore, a quantitative approach can enhance the ability



to compare political risk assessments (Brink, 2004:21). An investor can evaluate two investments on the basis of the same models and come to a conclusion as to which investment is the best. However, Brewer (1981:8) warns that caution should be taken not to totally disregard context and extrapolate historical situations to the future. Brewer (1981:8) uses the example of the Iranian war where the past stability of an authoritarian regime did not mean that the future would be stable. Brewer (1981:9) further points out that the fact that the analysis is quantitative does not mean that the political risk analysis can be successfully incorporated with financial risk in the overall investment risk. Bremmer and Keat (2009:5,9) also emphasise that political risk is hard to quantify because of the complexity and interrelationship of the sources of political risk events. They use the example of the difficulty in calculating the cumulative losses incurred as a result of the 9/11 terrorists attack in the US (Bremmer & Keat, 2009:23). Hough (2008:11) makes the point that numerical risk analysis is of no value without being complemented by qualitative assessments and proper explanations of the conclusion of the analyst.

Brink (2004:40) emphasises other problems with regards to the methodology used in political risk models, such as the fact that political risk factors from different levels of analysis are included in the same model. Brink (2004:40) warns against ecological and individualistic fallacies. Ecological fallacies refer to the mistake made to apply broad data on the ecological level to individual cases that can lead to false assumptions about a specific case. The individualistic fallacy on the other hand refers to the mistake to apply an observation that was done on an individual level incorrectly to the generalised level. A political risk indicator that implies a high risk for a certain business project will not necessarily be a high risk for other projects (Brink, 2004:40). To contribute to the objectiveness of the political risk analysis, an objective analytical framework should be used that is developed in accordance with a theoretical grounding (Robock, 1971:6; Kobrin, 1979:68). Kobrin (1978:120) argues that the use of mathematical models does not necessarily contribute to objectivity. Objectivity is rather reached by a better understanding of the political process and the operations of the firm. For example, Bremmer and Keat (2009:2) argue that the power dynamics of Chinese politics cannot be understood or studied in the same way as Saudi Arabia where politics is predominantly a family matter. Frei and Ruloff (1988:6) suggest that the qualitative methods should not be abandoned, but that they could be used in conjunction with quantitative methods because of the importance of context. Even in Brink's (2004) model that seems quantitative, the mixed method approach is used.

To conclude, what is important in political risk analysis is that a systematic approach is followed, that the context should be considered and that the model used should have a theoretical

grounding. These requirements have been taken into account in the decision to apply the Boshoff (2010) political risk model in the study, which is presented in the following section.

## **2.4 Political risk model for the oil and gas industry**

The purpose of this study is not to develop a new political risk model, but rather to use an existing model that would satisfy abovementioned requirements. Because of the importance of micro political risk, a further requirement is that the political risk model must be specific for the oil and gas industry and must make provision for macro as well as micro political risk factors and indicators thereof. While political risk models that are used in practice are not readily available as they are considered intellectual property of those companies that developed them, Boshoff (2010) developed a political risk analysis model for the oil and gas industry by conducting research on elements of these political risk models as reconstructed by various scholars. The model follows a mixed methods approach and incorporates quantitative and qualitative methods. This model will be used as a framework of analysis in the case study for a few reasons. The model is compact and based on a simple mathematical calculation, and incorporates macro and micro political risk factors and indicators into one model. While the political risk model developed by Alon and Herbert (2009) was also considered, their model only assesses micro political risk and should be used in combination with a different macro political risk model. That would make the study too complex.

Boshoff's (2010) model incorporates six political risk factors, i.e. political, economic, societal, petroleum, company and international factors that are analysed and rated in accordance with different indicators. Each indicator is analysed and rated individually on a scale of 0-5 and is used to determine the overall political risk rating. The requirements for a political risk model, i.e. a systematic approach, a consideration of the context and the basis of a theoretical grounding are therefore met by Boshoff's (2010) political risk model. Boshoff (2010) presents the model in two phases, where the first phase can be carried out without the knowledge of the investor and the second phase with the knowledge of the investor. For the purpose of this study, no distinction will be made between the two phases as an analysis will be carried out with the knowledge of a specific firm, i.e. CNPC. The following section as set out on pages 29 to 31 will explain the political risk model.



Political risk model for the oil and gas industry					
Political risk type	Factors	Indicators	Rating	Weight	Score
Host country political risk	Political	Regime/political stability	0-5	0-100%	
		War and security issues	0-5		
		Repatriation restrictions	0-5		
		Corruption/ poor governance	0-5		
		Unclear legislation/security of tenure	0-5		
		Investment constraints	0-5		
	Economic	Economic performance	0-5	0-100%	
		Balance of payments	0-5		
		Creditworthiness	0-5		
		Currency convertibility	0-5		
		Energy vulnerability	0-5		
		Public/private sector mix	0-5		
		Current account deficit	0-5		
	Societal	Internal violence	0-5	0-100%	
		Civil and labour unrest	0-5		
		Homogeneity	0-5		
		Ethnic conflict	0-5		
		Community opposition	0-5		
		Standard of living	0-5		
		Environmental activism	0-5		
	Petroleum	Ownership	0-5	0-100%	
		Domestic reserves/production	0-5		
		Host’s relative market position	0-5		
		Level and destination of exports	0-5		
		Strengths of national oil company	0-5		
		Role of the foreign company in industry	0-5		
		Oil and gas prices	0-5		
		Domestic ability to operate the industry	0-5		
		Ownership/contractual relationship between the firm and the host country	0-5		
Company political risk	Company	Nationality of the company	0-5	0-100%	
		World industry positioning	0-5		
		Special bargaining advantage	0-5		
		Host government relations	0-5		
International political risk	International	Host government international integration	0-5	0-100%	
		Host/home government relations	0-5		
		World petroleum market	0-5		
		World economic condition	0-5		
		The demonstration effect	0-5		
Total					

**Table One:** Political risk model for the oil and gas industry. Source: Boshoff (2010).

In applying this political risk model, each of the factors carries a percentage weight of a total 100 percent across all the factors. The weights are established by the analyst according to the impact that the factor has relative to the other factors. Each factor indicator is rated on a scale of 0-5, based on the following index:

- 0 - no risk
- 1 – nominal risk
- 2 – low risk
- 3 – medium risk
- 4 – high risk
- 5 – extreme risk

To get a weighted score for each factor, the sum of the ratings of each factor's indicators is multiplied by the percentage weight assigned to that factor and divided by the sum of the highest possible rating score for all indicators of that factor.

$$WS_1 = \frac{\sum_{i=1}^n R_i}{MTR} (W)$$

$WS_1$  = Weighted factor score

$R_i$  = Total rating of factor 1 (adding all indicators for the factor 1)

$i$  = Indicator

$W$  = Percentage weight of factor 1

$MTR$  = Maximum total rating of factor 1

An overall political risk rating (OPRR) for the firm operating in the country or region under investigation is calculated by adding the weighted factors' scores according to the following equation:

$$OPPR = (WS_1) + (WS_2) \dots (WS_n)$$

The OPRR determines the investment and political risk indication for the firm that operates in the country or region. The higher the overall risk rating, the greater the political risk that the investor and the investment faces. The indication is determined according to the following scale:

Rating	Investment indication	Rating	Political risk indication
0-10	Highly advisable	0-20	Nominal
11-20	Advisable		
21-30	Very low risk	21-40	Low
31-40	Relatively low risk		
41-50	Low to moderate risk	41-60	Medium
51-60	Relatively moderate risk		
61-70	Moderate to high risk	61-80	High
71-80	Relatively high risk		
81-90	Inadvisable	81-100	Extreme
91-100	Highly inadvisable		

**Table Two:** Scale for the investment and political risk indication. Source: Boshoff, (2010).

## 2.5 Conclusion

The objective of this chapter was to outline the theoretical framework in which political risk analysis is grounded, i.e. decision-making and problem-solving theory. Political risk analysis is an analytical tool that international businesses can use as a basis for making rational decisions about their investments and operations in a foreign country. The second objective of the chapter was to conceptualise key terms that will be used in this study and included FDI, risk, political risk, country risk, political instability, macro and micro political risk and political risk analysis. Thirdly, Boshoff's (2010) political risk model for the oil and gas industry was presented, which will be used as a framework for the political risk analysis for the case study in Chapter Four. To provide a background to the analysis of political risk in Chapter Four, and to answer the first sub-question of the study that asks what the features of the relationship between China and Sudan before South Sudan's independence are, the next chapter will contextualise Chinese FDI in Africa, in particular its role in the development of the Sudanese oil industry, and the historical factors that led to the independence of South Sudan in 2011.

## **Chapter Three: Contextualising Chinese foreign direct investment in the South Sudanese oil industry**

### **3.1 Introduction**

The purpose of Chapter Three is to contextualise Chinese FDI in the African oil and gas industry, in particular its investments in South Sudan. The first sub-question of the study will be answered in this chapter, which asks to identify the features of the relationship between China and Sudan before South Sudan's independence. The answer to this question will provide the context for the analysis of political risk faced by CNPC in South Sudan, which is necessary in order to answer the second sub-question of the study in Chapter Four. This chapter will firstly give a historical overview of China's FDI and its connection with the Chinese foreign policy. The second section will focus on Chinese investments in Africa, followed by a particular focus on the features of Chinese investments in the African oil and gas industry. In the fourth section the specific role of CNPC in the development of the Sudanese oil industry is contextualised, followed by an outline of the Sudanese civil war and the peace agreement that granted South Sudan the right to vote for self-determination. The last section puts the South Sudanese independence in context.

### **3.2 China's foreign policy and foreign direct investment**

In global terms, Chinese cumulative investments abroad are comparatively small and only represents 1,6 percent of the total world FDI stock<sup>17</sup> (MOFCOM, 2011). This picture might change with China's possession and use of large foreign currency reserves (Deng, 2009:77), as evidenced by China's rapid increase in yearly FDI. According to MOFCOM (2011), China has been the world's fifth largest source of FDI in 2010. Deng (2009:74) also notes that Chinese FDI has been the largest amongst emerging markets since the 1990s, coinciding with Chinese domestic economic liberalisation in 1992<sup>18</sup> (Buckley, Clegg, Cross, Liu, Voss & Zheng, 2007:504).

Chinese outward FDI was encouraged by the government's 'going out'<sup>19</sup> policy and China's accession to the World Trade Organisation (WTO) in 2001 (Buckley et al., 2007:504). In order to facilitate Chinese integration into the world economy and position itself into the economic world order, the Chinese government aimed to create a supportive environment for strong Chinese firms to invest abroad and become globally competitive MNCs (Deng, 2009:76).

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<sup>17</sup> FDI stock refers to the total value of the investments, not only the flows in a given year (Investor Dictionary, 2012).

<sup>18</sup> Enterprise internationalisation has been incorporated into the national economic development policy by Deng Xiaoping (Buckley et al., 2007:504).

<sup>19</sup> The "going out" policy is also referred to as the "going global" policy.

Promoted by preferential policies, SOEs<sup>20</sup> were encouraged to invest abroad in projects that supported the Chinese economic development model, which is built on heavy industrialisation, labour and capital intensive manufacturing industries and export-led growth (Liou, 2009:674; Jiang, 2009:587). To support the export of Chinese manufactured goods, FDI was firstly directed towards seeking new markets, mainly in developed countries (Buckley et al., 2007:504). Secondly, to gain entry into advanced markets, the Chinese government supported FDI that acquired advanced technological capabilities and managerial and professional skills, also mainly in the developed world (Deng, 2007:72). The third category of FDI that was of strategic national importance was investments that would secure access to domestically scarce products to support the domestic industrialisation, mainly in the energy and mineral sectors (Jiang, 2009:587). Kolstadt and Wigg (2009:9) note that being a latecomer in the global economy, Chinese investments in natural resources have been directed towards developing countries where there were still investment opportunities.

As part of this process of transforming the Chinese SOEs into modern market-oriented MNCs that are integrated into the world economy, the corporations or their subsidiaries were listed on the world's stock exchanges in order to improve their efficiency and profitability (Liou, 2009:675). Although the companies were listed, the majority of their shares were still held by the state (Deng, 2007:73). Jiang (2009:603) and Liou (2009:673) argue that the relationship between the Chinese state and the SOEs has changed with economic reforms and SOE managers have become more profit-oriented in their investment decision-making abroad. Although SOE executives can make decisions independently from the state, they are still appointed by the state, i.e. selected by the Communist Party of China (CPC), and according to Morck, Yeung and Zhao (2008:347), these executive positions are seen as a step in the political careers of the individuals. It is for this reason that Kolstad and Wigg (2009:6) suggest that the investment decisions of Chinese SOEs also reflect, apart from commercial objectives of profit-maximising, political objectives such as the promotion of domestic development, regime survival, social stability, the support of Chinese foreign policy or host country development. It therefore seems that despite being market-oriented MNCs, decisions made by Chinese SOEs still somewhat reflect dual objectives, i.e. profit-maximising and political goals.

It should however be taken into account that China is no longer a monolithic block that dictates the investment decisions of SOEs, because various institutions under the State Council are involved in the management and regulation of Chinese FDI (Jiang, 2009:603). Liou (2009:683) argues that this bureaucratic fragmentation has weakened the central state's control

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<sup>20</sup>An enterprise is referred to as a SOE when the state holds more than 50 percent of its equity (Kaplinsky & Morris, 2009:552).

over the corporations' decisions because of the conflicting goals of the bureaucratic institutions. MOFCOM is the central institution that directs non-financial foreign investments and operations and its functions include economic cooperation and the managing of foreign aid projects (Holslag, 2011:4; Corkin, 2011:67). The State Asset Supervision and Administrative Commission (SASAC) has authority over the management of overseas assets of the top 50 Chinese SOEs and also regulates the NOCs together with the National Development and Reform Commission (NDRC). The Ministry of Finance determines fiscal and taxation policies and is also the sole shareholder of China Exim Bank,<sup>21</sup> which is responsible for the financing of many of the overseas projects of Chinese firms, while the Ministry of Foreign Affairs (MFA) is in charge of overall foreign policy and strategy (Van der Lugt & Hamblin, 2011:38).

### **3.3 China's foreign policy and foreign direct investment in Africa**

As part of its “going out” policy, China's foreign policy towards Africa since the 1990s has mainly been directed by economic interest. The same upward trend of China's worldwide outward FDI has been reflected in China's FDI in Africa, which has grown from yearly investments of US\$317,43 million in 2004 to US\$2,1 billion in 2010<sup>22</sup> according to MOFCOM (2011) figures. While total cumulative Chinese investments in Africa have only been US\$899.55 million in 2004, it has grown to US\$13,04 billion in 2010 (MOFCOM, 2011). Although there has been a shift in recent years towards the retail and service sectors, Chinese investments in Africa are still dominated by the extraction of natural resources (UNCTAD, 2012:xvi). Kaplinsky and Morris (2009:56) mention that even investments in the construction of infrastructure focus on providing routes to enable the export of resources, such as oil pipelines or port facilities. As mentioned in section 3.2, the securing of scarce resources has been one of the objectives of China's “going out” foreign policy. Van der Lugt and Hamblin (2011:25) note that the structure of most African economies is based on trading in raw materials rather than manufactured goods, and therefore Africa is able and willing to provide China with these scarce resources. Consequently China had investment opportunities in African resources that were not always available in the developed world (Kolstadt & Wiig, 2009:560). However, Africa lacked opportunities for acquiring technical capabilities and the expansion of its export market due to a relative small domestic market, poor infrastructure and a large unskilled labour force (Van der Lugt & Hamblin, 2011:25).

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<sup>21</sup> China Exim Bank is wholly owned by the Chinese Ministry of Finance that reports directly to the State Council (Corkin, 2011:68). The bank facilitates the import and export of Chinese products and technology and promotes Chinese relations and trade with foreign countries (ICG, 2012a:9).

<sup>22</sup> This is the latest available data from MOFCOM (2011).

To demonstrate the importance of its economic interest in Africa, China created a platform for African and Chinese policymakers to enhance their relations and develop economic cooperation and trade, the Forum on China-Africa Cooperation (FOCAC), whose first ministerial meeting took place in Beijing during 2000<sup>23</sup> (Cissé, 2012:1). During this first meeting Beijing offered African countries a unique economic, political and security package that included debt relief, peacekeeping, cheap loans, support in multilateral forums, military deals and South-South cooperation (Jacobs, 2011:29). Sino-African relations were strengthened further in 2006 with the publishing of the China Africa Policy paper, apart from having a full FOCAC III China-Africa summit in Beijing (Grimm, 2012:2). Cissé (2012:2) comments that FOCAC has played a major role in facilitating Chinese investments in Africa by enhancing business relations between Chinese companies and African countries.

In the formal China-Africa and FOCAC policies, the principle of non-interference in the internal affairs of other countries<sup>24</sup> is one of the principles that is declared to guide the Sino-African relations (FOCAC, 2000; MFA, 2006). This principle manifested in Beijing's claim that its assistance to and economic dealings with African countries are free of political conditions such as human rights, good governance or democracy (Jacobs, 2011:30). Alden and Hughes (2009:572) argue that the policy of non-interference and non-conditionality has initially benefited Chinese investors over their Western counterparts to obtain access to African resources. Although this is still the official policy of China, Kuo (2012:3) remarks that it is not always possible for the Chinese government to uphold this policy in practice due to the extent of Chinese business interests in Africa, Western pressure and expectations by African countries. Alden and Hughes (2009:572) further explain that the Chinese government cannot remain indifferent to the politics of a host country because of the complex situation created by the diversity of Chinese actors involved in African investments. For example, the Chinese government was pressurised domestically to evacuate more than 30 000 Chinese workers from Libya during the political conflict in 2011 (ICG, 2012a:9).

The principle of non-conditionality is important in China's foreign aid policy of granting concessional loans<sup>25</sup> through China Exim Bank. There is no clear distinction between foreign aid and FDI support, as MOFCOM oversees Chinese FDI and also has authority over the Department of Foreign Aid. The Department of Foreign Aid in turn subsidises the loan interest of the

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<sup>23</sup> The ministerial meetings of FOCAC take place every three years (Grimm, 2012:1).

<sup>24</sup> This principle of non-interference is in line with Chinese principles that guide the government's other international relations.

<sup>25</sup> Concessional loans is conceptualised as the "medium- and long-term, low interest rate credit extended by China Exim Bank under the designation of the Chinese government with the nature of official assistance" (Corkin, 2011:68). These loans are granted without the conditions such as human rights or revenue transparency attached to them, as required by the IMF and World Bank (WB) (Mitchell, 2010:19).

concessional loans granted by Exim Bank (Corkin, 2011:68). Aid is granted in the form of development packages that are beneficial to African countries, but at the same time promotes Chinese foreign policy objectives (ICG, 2012a:9). Yeung and Liu (2008, cited in Corkin, 2011:75) call this system “economic diplomacy”, where interstate economic relations are conducted through the activities of national firms. Apart from profit and economic motives, political and diplomatic goals are met through these activities (Yeung & Liu, 2008, cited in Corkin, 2011:75). As a way of granting aid, China Exim Bank grants African countries concessional loans for development projects, with low interest rates and no conditions such as human rights or revenue transparency attached to it (ICG, 2012a:8). Because the contracts for the development projects financed by these loans have to be awarded to Chinese contractors, China’s foreign policy objective of new markets for its goods and services is also met in this way (Corkin, 2011:71). Often the repayment of the loans is secured by raw materials from the African country, thereby meeting another foreign policy objective of securing access to scarce natural resources (Corkin 2011:71). In this way, Beijing may assist SOEs to increase their investment prospects in Africa and at the same time obliges the firms to maintain close relations with the State Council and China Exim Bank (Holslag, 2011:4; Cissé, 2012:1).

### **3.4 China’s national oil corporations and foreign direct investment in Africa**

Historically there has always been a connection between trade, FDI and financial flows such as aid (Kaplinsky & Morris, 2009:561). This is also evident in China’s economic relations with African countries. According to Jacobs (2011:34), 90 percent of African exports to China in 2010 consisted of natural resources, mainly oil. The same trend is reflected in China’s FDI in Africa over the last decade. MOFCOM’s (2011:90) statistics for 2010 show that the majority of Chinese FDI in Africa has been in resource-rich countries, of which a large part is in oil-producing countries such as Nigeria, Algeria, Sudan<sup>26</sup>, Democratic Republic of the Congo (DRC) and Angola. However, it should be noted that despite the influx of FDI from Chinese oil companies, Chinese NOCs are still small oil producers in Africa (Jiang, 2009:595).

With China’s domestic development model of heavy industrialisation, the country has experienced rapid urbanisation and motorisation simultaneously since 2000 (Ma et al., 2012:43). Oil demand has risen in such a way that China is now the second largest oil consumer in the world and dependent on oil imports for more than 50 percent of its oil supply (Ma et al., 2012:45,47). While the Middle East has traditionally been the main supplier of Chinese oil imports, the political volatility of the region forced China to diversify its supply, and in 2008 Angola overtook Saudi Arabia as the main oil supplier (Croll et al., 2008:2). As mentioned in

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<sup>26</sup> Because South Sudan only became independent in 2011, the term Sudan refers to both countries in 2010.



section 3.3, Africa provided the Chinese NOCs with opportunities not always available in the oil industries of developed countries. For example, because of political opposition, one of China's NOCs, China National Offshore Oil Corporation (CNOOC), did not succeed in acquiring an American oil company, Unocal, in 2005 (Zhang & Ebbers, 2010:102). Alden and Hughes (2009:573) also point out that the lack of certain technical capabilities has been a hurdle for CNPC to invest in deep water oil exploration or oil extraction in polar regions. Taylor (2006:942) argues that the African oilfields provided Chinese NOCs not only with access to potential oil discoveries and unallocated oil reserves, but also with the opportunity to transform their NOCs into globally competitive MNCs as a way of integrating China into the world economy.

Transformation in the Chinese oil and gas industry started in 1988 with the establishment of the three NOCs that specialised in different activities (Liou, 2009:676). While CNPC were mainly responsible for onshore upstream<sup>27</sup> activities, CNOOC specialised in offshore upstream activities and Sinopec took control of the downstream business (Rui, 2010:59). Further restructuring by vertical integration in 1998 allowed CNPC and Sinopec to expand their operations into both upstream and downstream businesses and resulted in competition between the NOCs (Mitchell & Lahn, 2007:4). However, the corporations maintained their original advantage and today CNPC still dominates upstream activities and Sinopec downstream activities (Rui, 2010:59).

As argued in section 3.2, Chinese NOCs as state-owned enterprises act as profit-making corporations, but executives still have to find a balance between commercial and political interests when making business decisions. The Chinese NOCs are regulated by NDRC and SASAC, both entities that fall under the authority of the State Council (Liou, 2009:683). Liou (2009:683) argues that the goals of these two agencies are often in conflict with one another, because SASAC is concerned with commercial performance while NDRC is concerned with political goals such as the security of Chinese energy supplies. Therefore, despite being autonomous commercially driven entities, NOC executives are still obliged by the regulatory authorities to take national interest into account when making business decisions.

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<sup>27</sup>The oil industry is divided into upstream, midstream and downstream sectors. However, the midstream sector is usually included in the downstream category. The term "downstream" as used in this study will therefore include midstream activities. Upstream activities refer to the exploration and production sector, including the operation to bring the crude oil to the surface. Midstream activities include the processing, storage, marketing and transport of commodities such as crude oil (Petroleum Services Association of Canada, 2012). The downstream sector includes oil refineries, petrochemical plants, petroleum product distribution, retail outlets and distribution and therefore refers to the selling and distribution of products derived from crude oil (Fatal Attractions & European Coalitions on Oil in Sudan (ECOS), 2008:19).

### 3.5 China's role in the development of the Sudanese oil industry<sup>28</sup>

Encouraged by Beijing's foreign policy to invest abroad, CNPC, which originally specialised in upstream activities, started its foreign operations in the African oil and gas industry with the acquisition of large oil stakes in Sudan in 1997 (Rui, 2010:59). Close government relations between the two countries facilitated CNPC's entry into the Sudanese oil industry (Large, 2009:615). Large (2009:615) makes the point that the Chinese government has seen this investment as an opportunity for its NOCs to develop its foreign operations in accordance with the foreign policy goals of becoming integrated into the world economy. In another article, Large (2008:3) comments that the success that CNPC had with its operations in Sudan contributed to the fact that the China's State Council endorsed CNPC's strategy of purchasing foreign assets. It also led to stronger Sino-Sudanese ties, increased bilateral trade, and facilitated the entry of a wider variety of Chinese business enterprises in Sudan (ICG, 2012a:2). Until 2005 Sudan was the largest recipient of official Chinese FDI in Africa (MOFCOM, 2011:90). Although China's investments in other African oil producing countries such as Nigeria have overtaken its Sudanese investment (MOFCOM, 2011:90), ICG (2012a:27) notes that the importance of this initial implementation of China's "going out" strategy has given Sudan "symbolic importance".

China has been of significant importance for Sudan, not only as the largest economic investor and a central role-player in the development of its oil industry, but also as the largest buyer of its oil<sup>29</sup> (Kuo, 2012:3). Oil development in Sudan started in 1981 by Chevron after significant discoveries in Bentiu, later called Unity, and Heglig in the Muglad Basin<sup>30</sup> (Goldsmith, Abura & Switzer, 2002:223; ECOS, 2010:30). With the onset of the second Sudanese civil war in 1984, oil development stopped after a rebel attack on the Chevron base and the subsequent withdrawal of Chevron from Sudan (Harneit-Sievers, 2010:98). After more than a decade of civil war, the Sudanese government turned to China to restart the development of its oilfields to improve the state's poor financial situation<sup>31</sup> (Large, 2008:2). Sudan faced political isolation after US sanctions<sup>32</sup> prohibited American companies from investing in Sudan since 1997. China, who was keen to invest abroad, was seen as a potential ally because it also faced difficulties in its foreign relations because of the Tiananmen Square incident<sup>33</sup> in 1989 (Large,

<sup>28</sup> Refer to Table Four in Appendix A for a chronology of the conflict and oil development in Sudan.

<sup>29</sup> In 2011 China imported 66 percent of Sudanese (Sudan and South Sudan combined) oil (Kuo, 2012:3).

<sup>30</sup> Refer to Maps One, Two and Three in Appendix B.

<sup>31</sup> After the West pulled out of Africa with the demise of the communist bloc in 1989, foreign aid to Sudan fell dramatically and together with the costs of the civil war has led to a situation of high external debt, hyperinflation and declining GDP (Smith, 2011:174).

<sup>32</sup> The fact that the governing party of Sudan, the National Islamic Front (NIF), later called the National Congress Party (NCP), has been associated with terrorism, led to the US sanctions against Sudan in 1997. The United Nations (UN) has also announced sanctions against Sudan in 1996 (Large, 2008:2, Smith, 2011:175).

<sup>33</sup> The Chinese government was criticised for a military operation that killed hundreds of civilians during a democratic protest in Beijing's Tiananmen Square in 1989 (BBC News, 1989).

2008:2). From China's point of view, the lack of competition from American firms offered the Chinese NOCs the opportunity to develop its overseas investments on favourable terms (ICG, 2012a:2).

In 1997, CNPC became the operating company as well as the largest shareholder (40 percent) in the Greater Nile Petroleum Operating Company (GNPOC), a consortium with Petronas (30 percent) from Malaysia, Talisman Energy (25 percent) from Canada and Sudapet (five percent), the Sudanese NOC, as the other shareholders<sup>34</sup> (Rui, 2010:60). With concessions in blocks one, two and four in the Muglad Basin, GNPOC started with oil production of Nile blend crude<sup>35</sup> in the Heglig and Unity oilfields<sup>36</sup> (Energy Information Administration (EIA), 2012). After the completion by CNPC of the 1600 km Greater Nile Oil Pipeline (GNOP) from the Muglad Basin to Port Sudan on the Red Sea, Sudan exported its first oil in 1999 (Harneit-Sievers, 2010:98). Apart from operating the pipeline, CNPC further expanded its downstream activities with a 50 percent investment in the Khartoum Refinery in 2000 (Rui, 2010:64).

CNPC, with a 41 percent share in the Petrodar<sup>37</sup> consortium, expanded its Sudanese investment in 2000 with the development of block three and seven in the Melut Basin<sup>38</sup>, which gained significance with the discovery of a world class oil field in Palogue in 2002 (CNPC, 2012; EIA, 2012). The 1370 km pipeline, operated and owned by Petrodar, has linked these oil fields with Port Sudan since 2006 (ICG, 2012a:26; ECOS, 2010:14). The crude that is found in the Melut Basin, Dar blend, is a sour blend, which means that it has a high sulphur content and refineries have to be adapted to be able to refine this crude into useable products<sup>39</sup> (ECOS, 2010:9). CNPC also has production facilities in blocks six and fifteen, but GNPOC and Petrodar account for the largest portion of Sudanese (and after independence, also South Sudanese) oil production, making CNPC the largest oil investor in Sudan (Jiang, 2009:598; CNPC, 2012).

With the independence of South Sudan on 9 July 2011, oil fields have been divided between the two countries according to territorial position, shifting around 75 percent of oil production to South Sudan (BMI, 2012f:22). While the Petrodar operating areas, i.e. blocks three

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<sup>34</sup> Talisman sold its share in 2003 to the Indian NOC, Oil and Natural Gas Corporation (ONGC) Videsh due to political pressure from the Canadian government (Kobrin, 2004). With the independence of South Sudan, Sudapet's share was transferred to Nilepet, the South Sudanese NOC (ICG, 2012a).

<sup>35</sup> Nile blend crude is a sweet crude. This means that it has a low sulphur content and is easier and less costly to refine into useable products than blends with a higher sulphur content (WB, 2007).

<sup>36</sup> Refer to Maps One, Two and Three in Appendix B.

<sup>37</sup> Petrodar is also referred to as Petrodar Operating Company (PDO). Apart from CNPC, China holds a further six percent in this consortium through the other large NOC, Sinopec (Sautman & Yan, 2009:754). The other shareholders of Petrodar are Petronas (40 percent) from Malaysia, Al Thani (five percent) from United Arab Emirates (UAE) and Sudapet (eight percent). After South Sudanese independence Sudapet's share has been transferred to Nilepet, the South Sudanese NOC.

<sup>38</sup> Refer to Maps One, Two and Three in Appendix B.

<sup>39</sup> According to ECOS (2010:9), most refineries in Asia have started to upgrade their equipment in order to process Dar blend crude.

and seven in the Melut Basin, are completely situated in South Sudan and blocks six and fifteen, as well as all the pipelines and refineries, are completely situated in Sudanese territory, the oil fields in blocks one, two and four, operated by GNPOC, are situated in the common border area across both countries<sup>40</sup>, thereby splitting the operations of the consortium (ICG, 2011b:28). The situation has been complicated because of certain oilfields such as Heglig that are situated in the disputed border area between the two countries, despite the fact that it is treated by the international community as part of Sudan (EIA, 2012). CNPC has therefore been central to the development of the Sudanese oil industry and remains the largest investor in both countries after the independence of South Sudan in July 2011. According to Wang (2012), the investments in the two countries are CNPC's largest, most complete production chain outside China, with interests in exploration, pumping and refining. In order to understand the complex situation in which CNPC finds itself after the South Sudanese secession, the Sudanese civil war and the subsequent peace accord that led to the secession of South Sudan should be contextualised.

### **3.6 Civil war and peace in Sudan<sup>41</sup>**

While the Sudanese civil war of 22 years was caused and fuelled by a complex interrelationship of factors, for the purpose of this study it is only relevant to focus on two interrelated aspects, i.e. the north-south division and the impact of the discovery and subsequent exploitation of oil in Sudan.

Gonzalez (2010:71) argues that Sudan's north-south division has its roots in the colonial history of Anglo-Egyptian rule<sup>42</sup> when the north has been developed in terms of education, infrastructure and state administrative structures, while the southern provinces remained undeveloped. The "southern policy" of the 1920s reinforced separate development along ethnic, cultural and religious lines by the promotion of English and Christianity in the south rather than Arabic and Islamism that dominated the north (Woodward, 2011:6). Just before Sudanese independence in 1956, the first civil war broke out because of rebellion against southern subordination, which only ended in 1972 with the Addis Ababa peace accord that granted regional autonomy to southern Sudan (Fatal Attractions & ECOS, 2008:5; Christopher, 2011:128). Gonzalez (2010:74) argues that the discovery of oil in Sudan triggered renewed north-south conflict and contributed to the outbreak of the second civil war in 1983. President Nimeiri of Sudan tried to redraw the borders between the provinces, created Unity State to include the oil fields of the Muglad Basin and claimed control by the central government in Khartoum over the

<sup>40</sup> Refer to Map One in Appendix B.

<sup>41</sup> Refer to Table Four in Appendix A for a chronology of the conflict and oil development in Sudan.

<sup>42</sup> Sudan has been under the Anglo-Egyptian rule since 1898 (Gonzalez, 2010:71).

southern provinces and their oilfields (Kobrin, 2004:432; Maitre, 2009:57; Switzer, 2002:7). It is estimated that the second civil war, with the NCP as the governing party of Sudan and the Sudan People's Liberation Movement/Army (SPLM/A) under the leadership of John Garang as main actors, resulted in the deaths of over two million people, the internal displacement of more than four million people and the flight of 500 000 refugees across national borders (Large, 2009:613; Gonzalez, 2010:72).

Apart from the triggering of renewed conflict, the development of the Sudanese oil industry impacted the civil war in different ways. For the purposes of this study, it is important to look at three issues in order to understand the link between the civil war, the oil industry and CNPC. Firstly, the development of the oilfields has been associated with large-scale forced displacements and depopulation of the region (Gonzalez, 2010:7). Under the smokescreen of defending the oilfields and its investors, these displacements were carried out by government-sponsored militia that followed a strategy of division along ethnic lines<sup>43</sup> (Schumann, 2010:104). According to Thomas (2011:58), there have been suggestions of complicity by oil companies in the evacuation of the population and of the use of oil company facilities to launch air attacks. This intensified perceptions by the southerners and the SPLM/A that the oil companies took the side of the Sudanese government in the civil war (Thomas, 2011:58). Secondly, the revenue that the oil boom brought to Khartoum since exports started in 1999 enabled the government of Sudan to gain military strength to intensify its war efforts (Patey, 2007:999). This caused grievances not only against the government, but also against the international oil corporations that were associated with the government and the oil revenue (Thomas, 2011:58). China in particular has been associated with Khartoum's oil wealth because of CNPC's role in the development of the oil industry and because China has been one of the major export destinations for Sudan's oil. The huge military expenses also triggered grievances against China that have been associated with the supply of weapons to Sudan<sup>44</sup>. Thirdly, the increase in the oil revenue intensified the war because of resentment by the south of the unequal development in Sudan. The oil revenue allowed for increased public spending on development projects (Schumann, 2010:105), but most of the

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<sup>43</sup> While the SPLA strongly represented the Dinka ethnic group, the government backed the Nuer forces to challenge the SPLA in the oil producing areas (Fatal Attractions & ECOS, 2008:6; Goldsmith, et al., 2002:219).

<sup>44</sup> Although literature such as Large (2008:8), Wezeman (2010:62), Sautman and Yan (2009:756) and McFarland (2010:471) suggest that China has been a supplier of military weapons to Khartoum, there are differences on the extent of the military relationship between China and Sudan. However, for the purposes of this research the real extent of the relationship is not important, but rather the perceptions held by the SPLM/A. It is a general perception that the domestic Sudanese military industry was developed with the assistance of the Chinese government (Large, 2007:61).

development took place around Khartoum whereas the south has been marginalised<sup>45</sup> (De Waal, 2010:17).

While the development of the oil industry contributed to the escalation of the Sudanese civil war, the escalation of the conflict in turn hampered Sudan's ability to export the oil (Gonzalez, 2010:75). This situation was a major factor that led to the signing of the CPA in 2005 by the government's leading NCP and the SPLM/A after negotiations facilitated by the international community (Ahmed, 2009:138). The CPA established two governing entities, i.e. the Government of National Unity (GNU), a power-sharing government in Khartoum, and the semi-autonomous regional government, the Government of Southern Sudan (GoSS) situated in Juba (Thomas, 2010:2). The CPA gave Southern Sudan the right to vote on 9 January 2011 for unity with or secession from Sudan (Large, 2009:621). In accordance with a wealth sharing agreement, the CPA also stipulated that for this interim period Southern Sudan would get a 50 percent share of the oil revenue from oil produced within its territory (Ahmed, 2009:141; Gonzalez, 2010:75). This peace agreement contributed to a better political and security environment that enabled the development of blocks three and seven in the Melut Basin and the construction of the Petrodar oil pipeline that connects the oil fields with Port Sudan (ECOS, 2010:30). Without this pipeline, Sudan would not be able to export oil from the Melut Basin oil fields where large discoveries have been made.

### **3.7 Independence of the Republic of South Sudan**

On 9 January 2011, the Southern Sudanese people voted with a 98,3 percent majority in favour of secession from Sudan and the Republic of South Sudan became an independent country on 9 July 2011, with an estimated population of 8,2 million and a government led by the SPLM/A and its leader, President Salva Kiir (Aras, 2011; Dagne, 2011:15). However, the secession brought new insecurities to the region because of issues that had not been resolved before independence, despite the facilitation by the African Union High Level Implementation Panel (AUHIP) led by former South African president, Thabo Mbeki (African Union Peace and Security Council (AUPSC), 2012:1). Without an agreement on how to share the oil revenue after independence, both countries faced financial insecurities. While Sudan has lost a major part<sup>46</sup> of its oil revenue because 75 percent of the oilfields fell within South Sudanese territory, South Sudan faced the dilemma of being fully dependent on the Sudanese infrastructure, i.e. the pipelines and the port

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<sup>45</sup> According to De Waal (2010:170) 90 percent of infrastructure development in the early 2000s took place around Khartoum.

<sup>46</sup> According to Global Witness (2011:24) oil revenue represented 50 percent of Sudan's domestic revenue and accounted for 93 percent of exports, making oil exports one of the only sources of hard currency.



facilities, to export its oil (Global Witness, 2011:3; BMI, 2012h:44). The demarcation of the border between the two countries has been another unresolved issue, in particular the question on how the oil fields in blocks one, two and four in the Muglad Basin, which straddled the border, were owned and operated (Schankleman, 2011:5). Other unresolved issues are the question of whether Sudan's external debt of US\$38 million should be shared by South Sudan, whether the Abyei region on the border should be part of Sudan or South Sudan and questions regarding the citizenship of South Sudanese who live in Sudan and vice versa (EIA, 2012; De Waal, 2010:22).

### **3.8 Conclusion**

The purpose of this chapter was to contextualise Chinese FDI in the African oil and gas industry, in particular its investments in South Sudan, in order to answer the first sub-question of this study. This sub-question asks to identify the features of the relationship between China and Sudan before South Sudan's secession. The following features that are significant to this study have been identified:

Firstly, CNPC's initial engagement with Sudan was encouraged by Beijing's "going out" policy. Investments abroad were financially and diplomatically supported by the Chinese government to transform its SOEs into globally competitive MNCs as a way of integrating into the world economy. Because of the success of CNPC's investments in Sudan as the first major overseas investment by a Chinese NOC, Sudan's investments did not only have commercial value, but also symbolic value. It should however be noted that Beijing's control over the Chinese NOCs has weakened over the last decade because of bureaucratic fragmentation and NOC executives have to meet both commercial and political objectives.

A second feature of the relations between China and Sudan is Beijing's orthodox understanding of a policy of "non-interference" and "non-conditionality". CNPC did not have the same pressures from the Chinese government as Western firms had on political issues such as the war on terror or conditions such as human rights. These issues limited the investments in Sudan by other firms, but Chinese firms could expand their investments and use the advantage of concessional loans without conditions attached to them.

Thirdly, Sudan was of economic interest to China because of its oil reserves, which were important to secure Chinese access to scarce natural resources, in particular oil. Until 2005, investments in Sudan were China's largest FDI in African countries. Sudan was therefore of relevance for China in terms of the return of its investments for CNPC, but also in terms of securing oil imports from Sudan.

Fourthly, China was of extreme economic interest to Sudan as the largest oil investor, mainly investments held by CNPC. Chinese oil firms had an advantage in the Sudanese oil

industry because of the lack of competition after US investments and trade with Sudan were forbidden by sanctions. Because China could secure the import of Sudanese oil by these investments, China also adapted its refineries in order to process the crude blends from Sudan. In this way, China had a competitive advantage in terms of trade as a significant export destination for Sudanese oil. CNPC's investments in the downstream oil industry in terms of the construction and operation of the pipelines and the oil refineries further made Sudan dependent on investments by Chinese firms. Also of significance is the dependency of the Sudanese economy on oil revenue.

A fifth relevant feature is the close relations that the Chinese government and oil firms had with Sudan during the Sudanese civil war. The involvement of the Chinese oil firms in the development of the Sudanese oil industry, specifically its connotation with forced evacuations, and the impact of the oil revenue on the civil war, have created and sustained perceptions by the SPLM/A supporters that the Chinese government and CNPC have supported Khartoum in the civil war against the southern regions. China was associated with the increased military strength of Khartoum and marginalisation of the south while the northern region of Sudan developed.

It is important to take these features of the relations between China and Sudan into account when the political risk faced by CNPC in South Sudan is analysed in the next chapter, as 75 percent of Sudan's oil fields, a significant part of Chinese investments, were transferred to South Sudan after independence.

The first sub-question was answered in this chapter, while the second sub-question of the study, which asks what the level of political risk is that CNPC faces in South Sudan since the country's independence, will be answered in Chapter Four.



## Chapter Four: Political risk analysis for CNPC in South Sudan

### 4.1 Introduction

The purpose of Chapter Four is to analyse and measure the level of the political risk faced by CNPC in South Sudan since the country's independence in order to answer the second sub-question of the study. The results of the analysis will be examined in Chapter Five in order to answer the main research question, which asks what the main indicators of political risk are that Chinese corporations may face in the oil and gas industry in African countries. The industry-specific political risk model for the oil and gas industry of Boshoff (2010), as outlined in section 2.4, is used as a framework for the analysis. The political risk will be determined by analysing the risk factors, i.e. political, economic, societal, petroleum, company and societal factors. The data that will be used as a basis for the analysis will be limited to those data available as at 31 August 2012. Each factor is influenced by different risk indicators that are assessed separately on a scale of 0-5. In the last section, a final risk rating is calculated by applying the ratings to the political risk model.

### 4.2 Political risk analysis for CNPC in South Sudan

For each risk factor, the risk indicators are rated. For each risk indicator, a risk rating is presented and followed by a justification for the rating.

#### 4.2.1 Political risk factor: Political factor

##### 4.2.1.1 Political indicator: *Regime and political stability*

**Risk rating: Extreme: 5.** South Sudan became an independent state on 9 July 2011 after it was governed by a semi-autonomous GoSS under the CPA since 2005. Political stability in the country may firstly be threatened by the weak government and state institutions of the new country. Secondly, it may be threatened by the renewed mistrust and hostile relationship between the governments of Sudan and South Sudan following the lack of a resolution to the outstanding CPA issues, specifically with regards to the division of oil revenue between the two countries after South Sudan's secession.

##### 4.2.1.1.1 *Weak government and state institutions*

Despite governing Southern Sudan during the CPA period, Lacher (2012:5) argues that the SPLM is a weak government party because of internal divisions and factionalism with its roots in the civil war. Since the death in 2005 of the SPLM leader, John Garang, whose strong leadership unified the groups, the SPLM has suffered from splits and internal divisions (Ahmed, 2009:143).

Dagne (2011:12) and Lacher (2012:5) warn that the South Sudanese government may face political rivalries that might challenge its leadership. Since the April 2010 general elections there have been various rebellions against the SPLM government by former SPLA commanders (Dagne, 2011:13; UNSC, 2012a:15). However, despite the internal divisions, the SPLM is still seen as the liberation movement that brought peace to the region (El-Battahani, 2010:4). The UNSC (2012b) also reports that the hostile relations with Sudan since independence had a unifying effect throughout South Sudan. It is for this reason that Dagne (2011:12) makes the comment that the SPLM is “likely to dominate the political scene in South Sudan for years to come”. Although a change in government is unlikely, the government policies may still be influenced by shifts in the prominence of different factions and sentiments within the SPLM. Foreign oil companies are extremely vulnerable to possible changes in government policies such as its energy policy, tax policy or foreign policy.

Weak state institutions and the lack of state legitimacy also threaten political stability in South Sudan. Nyuot Yoh (2010:52) argues that the SPLM did not have a strong institutional framework because of the dominant role that the SPLA played during the civil war. Due to the marginalisation of the south in terms of education and socio-economic development by the Khartoum government, there is a shortage of trained civil servants to form competent state institutions (Lacher, 2012:27). This has led to the expansion of a patronage network in the current state structure to compensate for the lack of public service delivery such as education, water, electricity and transport infrastructure (Dagne, 2011:2; Lacher, 2012:27). This is evident from the 2011 state budget, where security and military expenses comprised 38 percent of the budget and only 21 percent were allocated to infrastructure, education and health combined (Lacher, 2012:29). Lacher (2012:27) also points out that the lack of a proper tax administration makes the state, and therefore also the financing of the patronage system, almost totally dependent on oil revenue. Because of the weak state institutions and poor public services, oil companies may face the risk of being targeted by the government either to fulfil some of the state’s functions or to pay more taxes.

A further possible threat to political stability is the military force in South Sudan. The government of South Sudan aims to gain support from the military through its patronage system, as evident from the large military state spending. However, the new government faces the problem of transforming the SPLA, a former guerrilla force with soldiers from different militant groups, into a regular army (Wezeman, 2010:62; BMI, 2012h:55). Lacher (2012:10) remarks that the army and security forces often present a threat to the civilian population, rather than protect them. The UNSC’s explicit mandate to the United Nations Mission in South Sudan (UNMISS) to protect civilians under imminent threat of physical violence is evident of this lack of security

provision by the state (Lacher, 2012:10). With a widespread proliferation of arms amongst civilians and non-state armed groups, and dissatisfied demobilised ex-combatants who face a lack of employment opportunities, the violent political culture as a legacy of the civil war may pose a threat to political stability (Wezeman, 2010:63; Nichols, 2011:13). Apart from threatening the power of the SPLM in the government, conflicts caused by divisions in the military and the availability of arms amongst civilians may threaten the security of the personnel and assets of oil companies, as well as their ability to continue their operations.

#### *4.2.1.1.2 Dispute with Sudan over oil revenue*

As discussed in section 3.7, Sudan lost a major part of its revenue with the transfer of 75 percent of the oil production to South Sudan at independence. South Sudan, on the other hand, faces the dilemma of being completely dependent on Sudan for its refineries and export infrastructure in the form of pipelines and port facilities (Large & Patey, 2010:14). Despite negotiations between the two countries under the facilitation of the AUHIP, no agreement had been reached before independence on the transit fees that South Sudan would have to pay for the use of the Sudanese oil infrastructure (AUPSC, 2012:1).

Khartoum rejected a deal proposed by Juba in July 2011, where after Juba received all the oil revenue in the absence of an agreement (BMI, 2011; Lacher, 2012:11). Lacher (2012:11) argues that the main reason for the continuation of the South Sudanese oil operations and exports during this period, was the pressure from the Chinese government on Khartoum. However, this situation could not last because of the worsening of Khartoum's fiscal position as a result of the loss of the oil revenue (Lacher, 2012:11). This led Khartoum to take action at the end of November 2011 to compensate for the loss of revenue. As Sudan had control over the export facilities at Port Sudan, Khartoum ordered the delay of two shipments of South Sudanese oil on 30 November and 3 December 2011 respectively (ICG, 2012a:27) and started to divert some of the South Sudanese Nile blend crude to the Khartoum refinery (EIA, 2012). In the absence of a deal, further shipments of South Sudanese oil were blocked and loaded onto Khartoum-chartered ships during January 2012 (ICG, 2012a:28). Khartoum claimed that it seized the oil because of the unpaid transit fees owed by South Sudan for the use of Sudan's oil pipelines (AUPSC, 2012:1). South Sudan, on the other hand, reported that it would treat the confiscated oil as stolen goods, as it had been the rightful owners of the oil (Government of the Republic of South Sudan, 2012). To resolve the dispute, the parties continued to negotiate in January 2012 under the mediation of the AUHIP, but after the AUHIP proposal was rejected by South Sudan, Juba made the decision to shut down its oil production until a fair deal was reached on transit fees (EIA,

2012). All South Sudan's oil operations were shut down incrementally until production ended completely at the end of January 2012 (ICG, 2012a:28; EIA, 2012).

BMI (2012h:46) argues that the rationale for the shutdown has been to put pressure on the international community to intervene and resolve the crisis, as the world crude supply would be affected, especially in China where the Dar and Nile blends of South Sudan are in particular demand<sup>47</sup>. Furthermore, with the negotiations on new oil contracts<sup>48</sup> with the oil companies that took place at the same time as the negotiations on the oil deal, Juba calculated that the Chinese government would pressure Khartoum to lower its pipeline charges (BMI, 2012h:46). ICG (2012a:28) comments that Juba was of the opinion that Beijing could play a larger role in pressing Khartoum to reach a deal. It was only on 4 August 2012 that Pagan Amum (2012), South Sudan's chief negotiator, announced in a press statement that the two parties had reached an agreement after pressure from the UNSC to close a deal under the mediation of the AUHIP. Amum (2012) stated that while Sudan previously demanded fees of up to US\$36 per barrel for the use of its oil pipelines, an agreement had been reached for combined fees of US\$11 per barrel for the GNPOC operated pipeline and US\$9,1 per barrel for the Petrodar pipeline for the next three and a half years, after which the fees can be renegotiated (Amum, 2012). Amum (2012) also declared that as a separate agreement from the transit fee agreement, South Sudan agreed to assist Sudan with a Transitional Financial Arrangement (TFA) because of the impact that the loss of the oil revenue had on Sudan's fiscal position. This financial assistance of US\$3,028<sup>49</sup> will be paid over a period of three and a half years as part of a "comprehensive package designed to ensure peace and security, respect for territorial integrity and cooperation" (Amum, 2012). The South Sudanese Minister of Petroleum and Mining, Stephen Dhieu Dau, said that as soon as the agreement was signed, South Sudan could resume preparation for its oil production (Dau, 2012). The two parties would resume their negotiations under the facilitation of former South African president, Thabo Mbeki, and the AUHIP on 4 September 2012 in Addis Ababa with the aim of reaching a final comprehensive agreement on the oil deal as well as other outstanding CPA issues such as security, border disputes, the status of Abyei and nationality issues<sup>50</sup> (Amum, 2012; Reuters, 2012). The UNSC has set a deadline of 22 September 2012 for the finalisation of the negotiations (Reuters, 2012).

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<sup>47</sup> It is reported that approximately five percent of China's imported crude oil comes from South Sudan (BMI, 2012f:19).

<sup>48</sup> New oil contracts have been negotiated during January 2012 with oil companies that operate oil fields in South Sudan. This issue is dealt with in detail in section 4.2.4.9.

<sup>49</sup> This amount reflects a third of the gap in Sudan's revenue resulting from the loss of oil revenue after South Sudan's independence (Amum, 2012).

<sup>50</sup> Refer to section 3.7 for more information on outstanding CPA issues and to section 4.2.1.2 on security issues with regards to the demarcation of the common border.

The dispute over the transit fees and the shutdown of the oil production had a severe effect on CNPC's investment in South Sudan in several ways. Firstly, the confiscation of the oil and the delay in shipments during December 2011 and January 2012 brought technical problems for oil production facilities, as the delay caused a storage crisis in the port with limited holding facilities (ICG, 2012a:27). Because of the delayed loading dates, oil tankers had to dock at considerable cost at Port Sudan, despite pleas from CNPC leadership (ICG, 2012a:28). Irregular schedules led to inefficiencies in oil production and other problems such as insufficient staffing and the movement of staff and personnel across the border (ICG, 2012a:28). Despite technical reports on these issues to the negotiation team in Addis Ababa by the CNPC representative, Sun Xiansheng, during January 2012, Juba still decided to shut down the production (ICG, 2012a:28).

Secondly, CNPC, which operates in both countries, had been dragged into the dispute that ultimately led to the expulsion of Petrodar's president from South Sudan on 20 February 2012. Despite the 2005 CPA, the two parties mistrusted one another and due to the NCP domination of the Ministry of Energy and Mining (MEM) during the CPA period, Juba had suspicions that Southern Sudan did not get its fair share of oil profits during that time<sup>51</sup> (Aras, 2011). Mistrust escalated with the oil dispute between Juba and Khartoum, which started at the same time that the oil companies renegotiated their contracts with Juba<sup>52</sup>. During the contract negotiations, Juba threatened that complicity with Khartoum's oil confiscation by any company would not be tolerated and could lead to the invalidation of oil contracts (BMI, 2012d). After the shutdown, Juba started to investigate the Petrodar consortium that operates blocks three and seven, as well as the Petrodar pipeline situated in Sudan (BMI, 2012d). According to ICG (2012a:30), South Sudanese officials found oil wells during the investigation that has not been recorded previously. This fuelled further mistrust against Khartoum for under-reporting oil output and Juba accused Petrodar of complicity with Khartoum despite Petrodar's explanations of the discrepancies (ICG, 2012a:30). Apart from this accusation, Juba also complained about Petrodar's delay in the relocation of its headquarters to Juba and a dispute over the future of Nilepet<sup>53</sup>, which holds a minority share in the consortium (ICG, 2012a:30). These accusations and, in Pagan Amum's<sup>54</sup> words, the "lack of cooperation" led to the expulsion of Petrodar's president, the Chinese national Liu Yingcai, from South Sudan on 20 February 2012 (Sudan Tribune, 2012). This expulsion may have a direct impact on CNPC's staff efficiency, and this incident has also demonstrated that

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<sup>51</sup> These discrepancies and its explanations have been published in a report by Global Witness in 2011. In terms of the CPA, Juba had to share in 50 percent of the oil revenue from production in Southern Sudan.

<sup>52</sup> For more detail on the contracts see section 4.2.4.9.

<sup>53</sup> Nilepet is the South Sudanese NOC.

<sup>54</sup> Pagan Amum is the secretary general of the SPLM and the top negotiator in talks with Sudan (Sudan Tribune, 2012).

Juba has the power to make decisions that may impact on CNPC's continuation of its operations, especially when the company is mistrusted for siding with Khartoum.

Thirdly, the shutdown of the South Sudanese oil operations by Juba has caused severe losses for CNPC as the largest shareholder in both oil consortiums. Apart from the loss in revenue, the companies still have regular overhead costs above additional costs to regulate the technical process of the shutdown. It has further been reported that oil companies sent some of their foreign workforce home (EIA, 2012), while CNPC subsidiaries that have been responsible for exploration, engineering, construction and drilling have been idle since the shutdown (ICG, 2012a:23). BMI (2012b) reports that according to industry sources it might take up to six months to resume production as water has to be removed from pipelines at huge costs. The shutdown of the oil operations has therefore had a huge negative effect on CNPC's income, and even when the decision is taken to resume production once a final agreement is signed, it would be costly and the retraining and repatriation of personnel would hamper production efficiency. Hence, it will take a long time for production to reach the same levels as before the shutdown.

While it seems as if a short-term agreement has been reached to secure the export of South Sudanese oil, on which CNPC's operations in South Sudan are dependent, a last point should be made on the long-term effect of a hostile Juba-Khartoum relationship on CNPC. While the agreement has secured South Sudan's use of Sudan's infrastructure for the next three and a half years, there is no long-term guarantee that the agreement will be extended. It is possible that CNPC can once again find itself in the same position after the end of three and a half years if the hostile relationship between the two countries persists. As an attempt to become independent from the Sudanese infrastructure, Juba has started negotiations with Kenya for the development of an oil pipeline to the port of Lamu, a Kenyan port that is still under construction (Dau & Murungi, 2012; BMI, 2012f:28). However, no funding has been secured for the project and doubts have been expressed as to the economic viability of the project<sup>55</sup> (Barber & Xiao, 2012:8; ICG, 2012a:25). It should also be taken into account that an alternative pipeline would make Sudan's pipelines obsolete and may cause losses to Petrodar and GNPOC as operating companies of the pipelines, as Kuo (2012:5) remarks. This can also undermine relations between Sudan and South Sudan, as well as between Sudan and the Chinese government and oil firms if Chinese companies are involved in the construction of the pipeline (Kuo, 2012:5). As CNPC has investments in both Sudan and South Sudan, these hostile relations may have a negative effect on the long-term security of South Sudanese exports, and at the same time the continuation of CNPC's operations cannot be guaranteed.

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<sup>55</sup> According to ICG (2012a:25) CNPC raised concerns about the recovering of the costs of such a pipeline because of the time and difficult terrain, which could exceed a reasonable transfer fee to be charged.



#### 4.2.1.2 *Political indicator: War and security issues*

**Risk rating: High: 4.** Apart from the oil dispute, the hostile relationship between Juba and Khartoum also manifested in the dispute over the demarcation of the common border that peaked in April 2012 as the armies of the two countries launched violent attacks across the border. The demarcation of the border has not been resolved before independence and is of significant importance for both countries as most of the oilfields are situated around the north-south border, including the Heglig oilfields that lie within disputed territory<sup>56</sup>. According to BMI (2012c), Heglig has been responsible for about half of Sudan's crude production since the independence of South Sudan. While Sudan and the international community, including the African Union (AU) and the UN, consider Heglig as part of the territory of Southern Kordofan in Sudan, Juba claims that Heglig belongs to South Sudan because it is situated south of the 1956<sup>57</sup> historical border that is supposed to be the official border between the two countries (Sudan Human Security Baseline Assessment (SHSBA), 2012; BBC News, 2012c). Although the Permanent Court of Arbitration (PCA) in The Hague ruled in 2009 that the Heglig oilfields fall outside the Abyei<sup>58</sup> border area, South Sudan argues that the court did not make a decision on whether Heglig falls within the Sudanese state, Southern Kordofan, or Unity State that is now part of South Sudan (SHSBA, 2012; Peter, 2010:68). Juba therefore argues that South Sudan still has a claim to Heglig (SHSBA, 2012).

According to De Waal (2010:18), both parties increased their military spending before independence to prepare for a renewal of hostilities between the two countries. Despite an agreement by both parties to respect each other's sovereignty and territorial integrity, since November 2011, UNMISS has reported air attacks by the Sudanese Armed Forces (SAF) on locations in the South Sudanese state of Upper Nile, and violence along the border in Unity State escalated in late March 2012 (UNSC, 2012a:7; UNSC, 2012b:4). The UNSC (2012b:6) reports that after air and ground attacks by the SAF on SPLA bases in Unity State on 26 and 31 March 2012, the SAF were pushed north towards the area of Heglig by the SPLA. The conflict escalated in April 2012 and on 10 April the Heglig oilfields were captured and occupied by the SPLA forces, forcing the oil operations of GNPOC to shut down (UNSC, 2012b:4). This was followed by several air attacks by the SAF on South Sudanese territory in Unity State (UNSC, 2012b:6) and allegations of attacks on oil installations were made (BMI, 2012h:58). It was only after international pressure that the SPLA forces withdrew from Heglig on 24 April 2012, and the SAF aerial bombardments ended on 5 May 2012 (UNSC, 2012b:4). After what has been seen as "the

<sup>56</sup> Refer to Maps Two and Three in Appendix B.

<sup>57</sup> Sudan gained independence in 1956.

<sup>58</sup> It is still an unresolved CPA issue whether the Abyei region is part of Sudan or South Sudan.

biggest north-south crisis since the second Sudanese civil war”, both sides returned to negotiations overseen by the AUHIP in Addis Ababa (BMI, 2012g:9), and specific negotiations on security and border issues would continue on 4 September 2012 (Reuters, 2012).

BMI (2012f:23) argues that the Heglig conflict reflects the “precarious nature” of the peace between the two countries and highlighted the importance of the undemarcated border region as a source of discontent between the two nations. Even before South Sudanese independence, De Waal (2010:13) summed up the relations between the two parties as “defensive, mutually sizing each other up, testing one another, and assuming the worst of one another”. BMI (2012h:5) makes the point that the Heglig incident is a demonstration of the capabilities of the South Sudanese forces that can match the SAF despite Sudan’s superior aircraft capabilities. Also, the fact that the UN Office of the Co-ordination of Humanitarian Affairs (UNOCHA) witnessed military build up on both sides demonstrates the ongoing mistrust between the two parties (BMI, 2012h:58). Despite the ceasing of violent cross-border attacks, the hostile relationship between the two countries and their military capabilities remains a threat to the security situation in the border areas.

This cross-border violence directly affected the security of oil companies, as most of the oil fields are situated in the border area. The air attacks by the SAF threatened to damage GNPOC’s assets in Unity State and GNPOC incurred severe losses by the shutdown of and damage to the Heglig oilfields.

#### ***4.2.1.3 Political indicator: Repatriation restriction***

**Risk rating: Low: 2.** Research done for this study could find no evidence of restrictions on the repatriation of funds or employees of foreign firms operating in South Sudan. This is confirmed by the fact that some foreign workers have been sent home after the shutdown of the oil production in January 2012, as EIA (2012) reports. Because China is the main buyer of South Sudanese oil<sup>59</sup>, it is unlikely that CNPC, as a Chinese SOE, will be affected by any repatriation restrictions of funds if it exists.

#### ***4.2.1.4 Political indicator: Corruption and poor governance***

**Risk rating: High: 4.** South Sudan suffers from a high level of corruption as the patronage system is integrated into the weak state institutions.<sup>60</sup> Extensive financial mismanagement and fraudulent conduct by some senior officials in the former government of Southern Sudan have

<sup>59</sup> According to EIA (2012), 66 percent of Sudan and South Sudan’s combined oil exports in 2011 were destined for China.

<sup>60</sup> See discussion on weak institutions in section 4.2.1.1.1.



been reported (UNSC, 2012a) and since independence the Anti-Corruption Commission has retrieved US\$60 million to the government coffers (UNSC, 2012b:2). Although ICG (2012a:12) comments that Chinese firms' business practices are not as concerned with norms of governance, capacity and accountability as the Western firms are, corruption and the patronage system can affect the Chinese oil companies mainly because it sustains a weak state administrative system. As Lacher (2012:7, 20) argues, the system of clientelism impedes the development of efficient state structures. Without strong institutions, company representatives have to rely on individuals in the clientelist system for certain decisions to be taken. With the lack of revenue from oil after the oil shutdown, the patronage network might crumble because of financial constraints, that in turn can cause grievances and fuel violent protests, causing a security threat to oil operations.

#### ***4.2.1.5 Political indicator: Unclear legislation/ security of tenure***

**Risk rating: Medium: 3.** ICG (2012a:11) reports that South Sudan's government policy planning remains limited and new civil servants are inexperienced in the area of petroleum. According to Barber and Xiao (2012:8), the new Petroleum Bill has not been implemented, but it "displays the intention to enshrine international best practices into law," that could mean that oil companies should pay more attention to social responsibility factors. Although extreme policy changes are not expected, the oil companies may still be at risk of the new legislation affecting them negatively.

#### ***4.2.1.6 Political indicator: Investment constraints***

**Risk rating: Medium: 3.** ICG (2012a:1) reports that Juba has begun to promote investment incentives, particularly for strategic and transformative investments. Existing investors in the oil industry were allowed to keep their investments and new oil contracts were agreed upon in January 2012. However, Juba insisted that the operations of the oil consortiums should be separated from their Khartoum operations (ICG, 2012a:23). This requirement has been especially problematic for GNPOC, which operates in blocks that fall across the territories of both countries. GNPOC, Petrodar and CNPC have already established administrative offices in Juba with the purpose of eventually duplicating the whole head office that is currently in Khartoum (ICG, 2012a:23). This has implications for CNPC's operations, especially in the GNPOC consortium, in terms of costs and efficiency as it can be hindered by the availability of qualified staff in South Sudan.

## 4.2.2 Political risk factor: Economic factor

### 4.2.2.1 Economic indicator: Economic performance

**Risk rating: High: 4.** According to the WB (2012), South Sudan is the most oil-dependent country in the world, as oil exports accounted for 70 percent of GDP and 99 percent of export revenue in 2011 (UNSC, 2012a:3). Therefore, the shutdown of the oil production since January 2012 has had a severe effect on the country's economic performance. The Republic of South Sudan National Bureau of Statistics (SSNBS) (2012) reported a GDP of US\$13,2 billion for 2010, but because of the large foreign component of the foreign oil industry, the Gross National Income (GNI) was much lower at US\$8 billion. The GDP per capita of US\$1 546 in 2010 was much higher than other East African countries, but the GNI per capita has only been US\$984 (SSNBS, 2012). Despite the oil income, the WB (2012) reports that South Sudan is the world's least developed country. Resources are also very unequally distributed, and ECOS (2010:27) remarks that most of the development in Southern Sudan has been around Juba where the government offices are.

While the formal economy of South Sudan is dominated by oil production, the informal sector mainly consists of subsistence agriculture (Schankleman, 2011:2). Despite rich water sources, the agriculture sector remain small and according to Lacher (2012:8), only one to two percent of the fertile land in the country is farmed. Poor infrastructure is a major obstacle to further development and it also limits the opportunities for economic integration with neighbouring countries (Verhoeven, 2011:13; BMI, 2012e:20). This makes South Sudan heavily dependent on food imports. Food imports are extremely expensive because of the depreciation of the South Sudanese pound caused by the limited availability of foreign currency after the oil shutdown. The Economist (2012b) reports that inflation reached 80 percent in May 2012.

The fiscal position of the South Sudanese government has deteriorated with the loss of 98 percent of its oil revenue since the shutdown of the oil production. Because of the weak state institutions, the government does not have the ability to raise taxes and relies on foreign reserves for budget expenses (BMI, 2012g:25; Lacher, 2012:8). The UNSC (2012b:3) reports that the government planned to borrow money and get income from selling oil and other resource concessions. Despite an austerity budget for 2012, government expenses remained high because of the military costs incurred to safeguard the border areas (UNSC, 2012b:3). The UNSC (2012a:19) comments that the weak fiscal position will severely impact on the government's ability to implement military and security reforms and to address the humanitarian crisis in the country. A volatile security situation may be created if armed militia fuel protests and may escalate into violent internal conflicts. With little money to spend on development outside the oil sector, the food crisis is unlikely to be resolved and inflation is likely to stay at high levels.

Therefore, the poor economic performance may threaten the security of oil corporations' operations if economic grievances of the community escalate to violent protests. Oil corporations may also face the risk of being targeted by the government to make up for the loss of the oil revenue in terms of taxes or regulations that require them to perform more development functions.

#### **4.2.2.2 Economic indicator: Balance of payments**

**Risk rating: High : 4.** No statistics were found during the research of South Sudan's current balance of payments<sup>61</sup>, but the trade deficit and the loss of foreign currency inflow suggest a negative balance of payments situation. The country has a trade deficit because exports ceased with the oil shutdown,<sup>62</sup> and the country is almost totally reliant on food imports. It is also unlikely that there has been an inflow of foreign currency from inward FDI, as BMI (2012g:15) reports that the government could only survive for the first half of 2012 by drawing on foreign currency savings from oil revenues accrued during times of high oil prices in 2011. A shortage in foreign currency can impact economic performance negatively, and the inability to import food can escalate the already severe humanitarian crisis. Economic and humanitarian grievances of the community may cause violent protests that may threaten the security of oil corporations.

#### **4.2.2.3 Economic indicator: Creditworthiness**

**Risk rating: High: 4.** With secession, South Sudan did not share in Sudan's external debt of US\$38 million (EIA, 2012), but the situation is not entirely finalised and still depends on negotiations during September 2012 (AUPSC, 2012:3). However, even without the share of Sudan's debt, the creditworthiness of the country has been impacted by the loss of its oil revenue (BMI, 2012a:19) and is heavily dependent on the resumption of oil production. This may affect oil corporations that plan to invest in oil infrastructure together with the South Sudanese state. For example, CNPC indicated that it considers investments in downstream projects such as refineries (ICG, 2012a:25) and the firm may face the risk that the state will not be able to finance its share. This may put pressure on the oil corporations to finance the full project, or being dependent on donors for finance.

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<sup>61</sup> Balance of payments refers to all the transactions made between a particular country and all other countries during a specified period of time. A negative balance of payments means that more money is flowing out of the country than coming in and vice versa (Investopedia, 2012).

<sup>62</sup> As 99 percent of exports are oil exports, this is the only source of hard currency.

#### ***4.2.2.4 Economic indicator: Currency convertibility***

**Risk rating: Medium: 3.** South Sudan's currency, the South Sudanese pound, has been highly volatile and is traded on two parallel markets (African Economic Outlook, 2012). The currency has depreciated severely because of the limited availability of foreign currency after oil exports ceased in January 2012 (UNSC, 2012b:4). This had a huge impact on the South Sudanese economy in terms of its balance of payments, trade deficit and the inflation rate. As discussed in section 4.2.2.1, this impacts food prices that in turn may cause economic grievances, and can ultimately lead to violent protests, impacting on the security of oil corporations. Apart from the indirect effect, CNPC will not be directly affected by the currency volatility, as oil is traded in US dollars and a large part of South Sudan's oil exports are destined for the Chinese market. The increased costs that currency devaluation might bring, will also not have a huge effect on CNPC, as all the oil production is for the export market<sup>63</sup> and the firm should have enough foreign currency to be able to pay its expenses when production resumes.

#### ***4.2.2.5 Economic indicator: Energy vulnerability***

**Risk rating: Extreme: 5.** Because of South Sudan's extreme dependency on oil revenue in terms of GDP and government revenue,<sup>64</sup> its economy is highly vulnerable to external pressures and oil price fluctuations. For example, in 2009 the government had to cut its budget by a third when oil prices fell after the global financial crisis (Lacher, 2012:8). Due to the dependency on foreign investors in the oil industry, this extreme oil dependency would normally be an indicator of lower risk for foreign investors. However, South Sudan is not only extremely dependent on the foreign investors, but also on other countries for exporting its oil. As a landlocked country, South Sudan is dependent on other countries' infrastructure, at this stage Sudan, for the export of its oil, making the economy even more vulnerable (Lacher, 2012:11). This extreme vulnerability led to severe losses for CNPC after the shutdown of the oil production caused by the dispute with Sudan. CNPC is therefore dependent on good relations between Khartoum and Juba to enable the oil to be exported. As discussed in section 4.2.1.1.2, even if an alternative pipeline was built to Kenya, South Sudan's exports would remain dependent and vulnerable.

#### ***4.2.2.6 Economic indicator: Public/private sector mix***

**Risk rating: Extreme: 5.** As oil is considered a national asset and the South Sudanese government has Exploration and Production Sharing Agreements (EPSAs)<sup>65</sup> with oil companies,

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<sup>63</sup> South Sudan does not currently have any refining facilities for the domestic refinery of crude oil for the processing of useable consumer products.

<sup>64</sup> For detail refer to section 4.2.2.1.

<sup>65</sup> For further detail on these contracts see section 4.2.4.9.

the oil sector can be classified as the public sector. With the oil sector that makes up 70 percent of GDP (UNSC, 2012a:3) and very little business activity outside Juba (African Economic Outlook, 2012:6), the public sector dominates the formal economy. Without a large private sector that can form a substantial tax base, the oil companies are highly vulnerable to government decisions, especially as they are easy targets for the government as a source of extra income.

#### ***4.2.2.7 Economic indicator: Current account deficit***

**Risk rating: High: 4.** No statistics were found during the research of South Sudan's current account<sup>66</sup>, but a deficit for 2012 is suggested by the ceasing of oil exports<sup>67</sup> and the total dependence on imports of food and consumer products. Although this situation may change when oil production resumes, BMI (2012b) reports that it might take up to six months to resume production, and not necessarily at full production levels. The lack of foreign currency may impact on the country's ability to import food, that in turn might lead to economic grievances and violent protests and negatively affect the security situation of oil corporations.

### **4.2.3 Political risk factor: Societal factor**

#### ***4.2.3.1 Societal indicator: Internal violence***

**Risk rating: High: 4.** As a legacy of the Sudanese civil war, which has been far more complex than the north-south division<sup>68</sup>, internal divisions within the north and within the south still have an influence on internal violence in both Sudan and South Sudan. Internal violence within Sudan might also have a spill-over effect on the security situation in South Sudan.

Two of Sudan's states bordering South Sudan, Southern Kordofan and Blue Nile, have been affected by ongoing conflict between the SAF and SPLM-North<sup>69</sup> (SPLM-N) rebel groups that peaked during 2011 (Dagne, 2011:1). These conflicts have fuelled mistrust between the Sudanese and South Sudanese government as the Sudanese government accused the SPLM of supporting the SPLM-N in trying to topple the Sudanese government, despite the fact that the SPLM insists that it broke ties with the SPLM-N after independence (BMI, 2012a). The internal conflicts in Southern Kordofan and Blue Nile affected the security situation in South Sudan, especially in the bordering states of Unity and Upper Nile, because of the spill-over effect of violence and the influx of refugees (ICG, 2011a). Both states have large refugee camps close to the border (ICG, 2011b:24; The Economist, 2012a), that put severe strain on the already dire

<sup>66</sup> The current account refers to the difference between a nation's total exports and total imports of goods, services and transfers, excluding financial assets and liabilities (Investopedia, 2012).

<sup>67</sup> Oil exports accounts for 99 percent of total exports.

<sup>68</sup> A detailed discussion of the civil war falls outside the scope of this study.

<sup>69</sup> After independence, the SPLM forces situated in Sudanese territory formed the SPLM-N. The SPLM-N has been declared an illegal party in Sudan after violence broke out in September 2011 in Blue Nile (Dagne, 2011:1).

humanitarian situation. Together with the proliferation of arms and the violent political culture as a legacy of the civil war, the situation may pose a security threat to the oil consortiums with operations in the region, such as Petrodar and GNPOC.

Van der Zwan (2011:14) argues that many of the civil war grievances have resurfaced with the prospect of the independence of South Sudan. This can explain why rebel activity within South Sudan has been a continued source of instability since independence. While the UNSC (2012a:15) reports that in 2011 350 000 people were displaced within South Sudan because of internal violence, Wheeler (2012:9) points out that there are still tension in most South Sudanese states, including Jonglei, Unity and Upper Nile, where most of the oil production take place. According to McNamee (2012:10) internal conflicts in South Sudan have worsened in 2012, despite the involvement of UNMISS and the success of SPLM to crush several rebel factions. The UNSC's (2012b:6) July 2012 report notes that the situation in Unity State and Jonglei has improved, but that militia groups were still mobilised in Upper Nile. The rebellions worsened relations between Sudan and South Sudan as Juba accused Khartoum of supporting the rebel groups to overrun oil installations and topple the government, just as Juba is accused of supporting rebel groups in Sudan, despite the denial of accusations by both parties (BMI, 2012h:59; UNSC, 2012b:6).

Internal violence in Unity and Upper Nile affects the security of the region, and may threaten the security of the operations of the oil facilities of GNPOC and Petrodar that are situated in these two states. The security of the pipelines on which the oil exports are dependent can also be directly affected by internal violence and rebel attacks in Southern Kordofan and Blue Nile in Sudan. Although rebel groups have not directly targeted the oil companies, on 28 January 2012 there was an attack by the SPLM-N in Southern Kordofan on Chinese workers from Power Construction Corporation of China. Twenty nine Chinese nationals were abducted, of which 18 escaped, one was killed and the rest were released on 7 February 2012 (Quarterly Chronicle and Documentation, 2012:571; BBC News, 2012a). BMI (2012g:27) argues that oil companies within the region may run the risk of being targeted by rebel groups as attacks on foreign companies can make a huge impact because of the publicity. Even if the oil companies are not directly targeted, rebel activities may pose a risk in terms of the general security environment in the region in which they operate, which can hamper its operations and ability to export. Barber and Xiao (2012:7) report that some Chinese companies they have interviewed are concerned about the deteriorating security situation along the border. However, according to Barber and Xiao (2012:7), the security situation around Juba, where the headoffices of the oil consortiums are situated, is relatively stable.



#### **4.2.3.2 Societal indicator: Civil and labour unrest**

**Risk rating: High: 4.** Van der Zwan (2011:14) argues that the South Sudanese government has been unable to meet the high expectations that the South Sudanese had of what their life would be after independence. Grievances such as poor public services and the lack of development can easily result in civil unrest, as evidenced by protests in Khartoum during July 2012 (Reeves, 2012). Although there have not been reports of civil unrest in South Sudan, the circumstances of poor public service delivery, a dire humanitarian situation and economic grievances may pose a risk of civil unrest that may hold a security threat for oil companies.

Oil companies may also face the risk of labour unrest. Most employees of the oil companies have been of northern Sudanese origin,<sup>70</sup> as regulations have disadvantaged people from the southern region for employment<sup>71</sup> (EIA, 2012; ECOS, 2010:22). Because of the uncertainty around the citizenship and status of South Sudanese in Sudan and vice versa, there was an incident in Unity State during April 2011 where several hundred oil workers and engineers of northern Sudanese descent were expelled from Southern Sudan by the governor of the state (ICG, 2011b:29). It was only after Juba interfered that the employees returned (ICG, 2011b:29). However, after independence many of the Sudanese left South Sudan because of the uncertainty regarding their citizenship (BMI, 2012f:39). When oil companies resume production, they may face labour unrest because of resentment by South Sudanese for not being employed in skilled jobs, or because of the lack of a skilled workforce. According to ICG (2012a:23), the oil consortia plans to address this issue with involvement in the establishment of a petroleum engineering department at the Juba University.

#### **4.2.3.3 Societal indicator: Homogeneity**

**Risk rating: High: 4.** Despite perceptions of a homogenous north-south division of the Sudanese population<sup>72</sup> after South Sudan's independence, the WB (2012) reports that the country has more than 200 ethnic groups. Christopher (2011:128) notes that there is considerable ethnic, religious and linguistic diversity among the society that was exploited by Khartoum during the civil war. Van der Zwan (2011:14) and Medani (2011:145) argue that the complex multi-ethnicity around the border area contributes to territorial disputes that make the demarcation of the border a complex issue. Dinka dominance in the SPLM is also a source of grievance (Ahmed, 2009:145)

<sup>70</sup> According to Rui (2010:61), 93 percent of GNPOC's employees had been from Sudanese origin.

<sup>71</sup> According to ECOS (2010:22), oil consortiums had to recruit employees through a local company, Petroneeds, which only accepted applicants that could provide a certificate for the completion of military service in the Sudanese government army.

<sup>72</sup> Perceptions of homogeneity have its origins in the Arab/Africa and Islam/Christian division that was one of the sources of the Sudanese civil war.

and the marginalisation of minority groups can easily spark ethnic conflict, as witnessed by the long Sudanese civil war. This may pose a security risk to oil corporations.

#### **4.2.3.4 Societal indicator: Ethnic conflict**

**Risk rating: High: 4.** Ethnic conflict as part of the complex conflict system in Sudan and South Sudan is still ongoing in the states where oil is produced, i.e. Unity and Upper Nile, as discussed in section 4.2.3.1. For McNamee (2012:10), the ethnic conflict over resources often has deeper roots, such as the proliferation of arms, extreme poverty and the marginalisation of smaller ethnic groups<sup>73</sup>, all features of the situation in South Sudan. Van der Zwan (2011:14) argues that these conflicts in South Sudan will continue to threaten socio-economic development in the absence of state provision of security and justice, and in turn may threaten the security of oil corporations.

#### **4.2.3.5 Societal indicator: Community opposition**

**Risk rating: High: 4.** According to ECOS (2010) and Large (2009:624) there are widespread community grievances against oil companies in South Sudan's oil-producing regions, mainly because the community has not benefited from the oil wealth. Oil companies have been accused of following a top-down approach and not involving the community when social projects such as the building of clinics and schools have been taken on (ECOS, 2010:21,28). ECOS (2010:27) also comments that oil companies face resentment by the community because of the violent displacements with the development of the oilfields during the time of the Sudanese civil war and the delays in compensation for victims. Barber and Xiao (2012:8) note that South Sudanese officials are still dissatisfied with the lack of attention that corporate social responsibility gets in the actions of the Chinese oil companies. For example, The Economist (2012a) reports that Petrodar has been criticised for its reluctance to help aid agencies in the refugee camps in Upper Nile State, which have been flooded during the rainy season, despite the consortium's access to an all-weather landing strip in the area. South Sudanese resentments against oil corporations extend to grievances in the workforce because of the discrimination against Southern Sudanese, as preference was given to northern Sudanese for employment (ECOS, 2010:28). New contracts that the oil companies signed with the government in January 2012 strengthened previously neglected social and employment standards (ICG, 2012a:ii). Although there are no recent reports of community opposition that turned into attacks on oil operations, ECOS (2010:20) reports that GNPOC incurred damages of US\$10,7 million during the first half of 2008 due to incidents of sabotage and vandalism. Apart from the threat of being targeted physically, oil corporations may also face the risk of having to incur major costs to secure community corroboration.

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<sup>73</sup> This point was also made in section 4.2.3.1.



#### **4.2.3.6 Societal indicator: Standard of living**

**Risk rating: Extreme: 5.** A very low living standard is reflected in the fact that 90 percent of the population of 8,2 million South Sudanese live on less than US\$1 a day, as the UN reports (EIA, 2012). Food insecurity remains the main threat to South Sudanese because of the loss of oil revenue, a small agriculture sector, a poor harvest and inaccessibility of areas that need humanitarian aid (UNSC, 2012a:14; UNSC, 2012b:17). The UNSC (2012b:17) reports that 70 percent of the countryside is inaccessible for humanitarian aid workers during the rainy season because of the poor infrastructure. The situation has worsened with the influx of refugees from Sudan, especially to the states of Upper Nile and Unity, and the large number of internal displacements caused by internal violence (The Economist, 2012b). Severe strain is also placed on the social infrastructure by the returning of South Sudanese from Sudan, who return without any economic prospects. The UNSC (2012a:15) estimates that about 500 000 people returned to South Sudan between September 2011 and February 2012. Apart from poor economic development, South Sudan also has extremely low levels of human development (BMI, 2012g:11) as evidenced by the very low literacy rate of 27 percent, low attendance of schools and poor health care (Dagne, 2011:14; African Economic Outlook, 2012:8). Although the national development plan of the new South Sudanese government prioritises social and human development, this plan has not yet been implemented due to budget constraints (African Economic Outlook, 2012:8). The poor human development levels may firstly have an impact on the efficiency of oil operations once production resumes, as according to Barber and Xiao (2012:8), new contracts with the oil companies have stricter requirements of local employment targets for companies. Oil corporations may firstly face the risk of inefficiency due to an unqualified or unskilled workforce. Secondly, poor living standards may create and sustain grievances against the government, and also against the oil companies that may be associated with government wealth. Oil companies may face the risk of being targeted in community unrest because of this association. Thirdly, poor living conditions may fuel and sustain violence in an already violent society, which may hold security threats for oil companies.

#### **4.2.3.7 Societal indicator: Environmental activism**

**Risk rating: Medium: 3.** ECOS (2010:33) argues that poor environmental law enforcement in Sudan during the development of the oil industry has led to severe environmental damage such as deforestation, water contamination and the diversion of the natural flow of the Nile waters. Since independence South Sudanese authorities are more interested in rectifying the environmental damage and have drafted an environmental policy to mitigate some of the environmental threats (ICG, 2011b:30; African Economic Outlook, 2012:7). This has also led to significant changes to

contracts with the oil companies in terms of environmental standards (ICG, 2012a:ii). Oil corporations might be obliged to pay more attention to environmental issues, although it is unlikely that policies will be adequately monitored due to the weak state institutions.

#### **4.2.4 Political risk factor: Petroleum factor**

##### ***4.2.4.1 Petroleum indicator: Ownership***

**Risk rating: Extreme: 5.** Under Sudanese law, all petroleum found within its territory is deemed to be the property of the state (BMI, 2012f:37) and ownership of the oil reserves on South Sudanese territory were transferred to the new state after independence (AUPSC, 2012:3). However, there are still ownership disputes of certain oilfields such as Heglig because of disagreements on the demarcation of the border. The government of South Sudan has already signed new contracts with the oil consortiums based on EPSAs (ICG, 2012a:22), which means that the profits from the oil operations are shared equally by the consortium and the government (BMI, 2012f:37). The oil companies have no right to the oil reserves, only to operate the oilfields. This situation may increase the risk that oil companies can lose their investments if the state decides to take over the operation of the oil fields and cease the contracts.

##### ***4.2.4.2 Petroleum indicator: Domestic reserves and production***

**Risk rating: High: 4.** Most of South Sudan's proven oil reserves lie in the Muglad and Melut Basins, which is currently operated by GNPOC and Petrodar respectively. Estimates of South Sudan's oil reserves vary from 4,2 billion barrels by Wood MacKenzie (according to BMI, 2012f:22) to 7 billion barrels reported by the South Sudanese energy minister, Dhieu Dau (BMI, 2012b). BMI (2012b) has a conservative estimate of 4,85 billion barrels as there is no comprehensive data available on the potential for greenfield investment. According to ECOS (2010:24), results of other exploration blocks did not show much potential. South Sudan's reserves are considerably smaller than the oil reserves of other large oil producers in Africa such as Nigeria and Angola (Harneit-Sievers, 2010:98). Also, according to Schankleman (2011:3), the WB expects that production levels will start to decline sharply in 2015. With limited reserves and declining production levels, South Sudan's proven oil reserves are not as relevant to China's global energy strategy as they once were when CNPC first invested in Sudan (ICG, 2012a:ii). The declining reserves may pose the risk of poor long-term prospects for growth in the oil industry, which may result in a low return on investment.

#### ***4.2.4.3 Petroleum indicator: Host country's relative market position***

**Risk rating: Medium: 3.** According to Schankleman (2011:2), Sudan and South Sudan's combined production accounts for 0,6 percent of the world's oil output. On the global stage, South Sudan is only a minor producer, which may pose the risk that the lack of expansion opportunities can lead to lower returns on investment. However, it should be noted that South Sudanese oil is still important to China<sup>74</sup>, where oil consumption and demand is increasing.

#### ***4.2.4.4 Petroleum indicator: Level and destination of exports***

**Risk rating: High: 4.** Because South Sudan does not have any oil refineries, all of its production is exported, mainly to Asia. EIA (2012) reports that in 2011, 66 percent of Sudan and South Sudan's combined crude exports were destined for China while the rest were exported to Malaysia, Japan, UAE, India and Singapore. China has been a preferred destination because of US sanctions<sup>75</sup> and because of the limited market for Dar blend crude that is produced in the Melut Basin by Petrodar (BMI, 2012f:39), as refineries need to be adapted to fulfil the special requirements needed to refine the Dar blend crude (Schankleman, 2011:3). While the high level of exports would normally be an indication of lower risk for foreign firms because they would be less dependent on the host country, in this case the high export level may pose an extreme risk to oil producers because of South Sudan's landlocked geographical position. If South Sudan is unable to export its oil, oil corporations will not be able to continue their operations. However, the fact that such a high level of exports is for the Chinese market, justifies a somewhat lower risk rating than extreme as it is unlikely that South Sudan will lose China as an export market. Because of Beijing's official policy of non-interference in political issues of foreign countries in, it is unlikely that Beijing will introduce trade restrictions on South Sudan.

#### ***4.2.4.5 Petroleum indicator: Strength of national oil company***

**Risk rating: Low: 2.** After independence, the South Sudanese NOC, Nilepet, took over the five percent share in GNPOC and eight percent share in Petrodar that was held by Sudapet, the Sudanese NOC, although the details of the transfer are still a matter of dispute (ICG, 2012a:20). Despite the dispute, South Sudan has started to market and sell its oil independently from Khartoum (ICG, 2012a:20). However, Nilepet is still a weak institution mainly because of a lack of experienced and trained staff (IGC, 2012a:20), making nationalisation unlikely because of the extreme dependency on foreign oil firms to operate the South Sudanese oil industry.

<sup>74</sup> According to BMI (2012f:19), approximately five percent of Chinese oil imports come from South Sudan.

<sup>75</sup> US sanctions have been lifted against South Sudan in December 2011.

**4.2.4.6 Petroleum indicator: Role of the foreign company in the national oil industry**

**Risk rating: Low: 2.** CNPC played a central role in the development of the oil industry in Sudan, and the company remains the largest investor in the South Sudanese oil industry since independence with its shareholding of 40 percent in GNPOC and 41 percent in Petrodar. CNPC's large investment, its experience in Sudan and the wide range of activities that not only includes prospecting and well drilling, but also engineering and construction (BMI, 2012f:43), provided CNPC with a bargaining advantage when the South Sudanese government had to sign new agreements with the oil companies. Juba renewed CNPC's contracts because of mutual interest (Large, 2012:18). The oil shutdown made Juba even more dependent on CNPC, as the negative message that the shutdown sent to potential Western investors may make them reluctant to invest (ICG, 2012a:24). Because of the dependence on CNPC, there may be a lower risk of being targeted by the government with measures such as expropriation.

**4.2.4.7 Petroleum indicator: Oil and gas prices**

**Risk rating: Low: 2.** The Brent crude price was US\$113,93 per barrel on 31 August 2012 (YCharts, 2012), after a high yearly average price of US\$111 per barrel in 2011 that peaked in April 2012 at around US\$120 per barrel (UN, 2012:4). The UN's (2012:4) forecast for 2012 is an average of US\$110 per barrel and for 2013, US\$100 per barrel. However, South Sudanese Dar blend crude that is produced by Petrodar in block three and seven in Upper Nile State, is traded at a substantial discount because of its limited market<sup>76</sup> (Schankleman, 2011:3). Current high oil prices reduce the risk of losses for oil companies because of higher profit margins.

**4.2.4.8 Petroleum indicator: Domestic ability to operate the industry**

**Risk rating: Nominal: 1.** Government officials of South Sudan have limited experience in the oil industry, as it was run by Khartoum's MEM before South Sudan's independence (ICG, 2012a:20). South Sudan is totally dependent on foreign oil firms to operate the industry because of a shortage of experienced staff, a lack of technology, and a lack of domestic investment capital (Thomas, 2011:57). As discussed in section 4.2.4.5, Nilepet is a weak institution with no capacity to operate the industry. Because of this high dependency on foreign oil firms, the risk of measures such as nationalisation or expropriation is nominal.

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<sup>76</sup> Sales to the US were prevented because of US sanctions since 1997 and Sudanese oil was therefore mainly sold to the Asian markets, where the refineries have been equipped to process the oil (Schankleman, 2011:3).

#### ***4.2.4.9 Petroleum indicator: Contractual relationship between the firm and the host country***

**Risk rating: Extreme: 5.** On Juba's insistence, GNPOC had to separate its Sudanese and South Sudanese operations after South Sudan's independence and GNPOC, Petrodar and CNPC have established offices in Juba (ICG, 2012a:23). Negotiations on new contracts between Juba and the oil firms took place at the same time in January 2012 as negotiations on Juba's dispute with Khartoum over transit fees. New five-year transitional contracts were signed on 13 January 2012, around a week before Juba decided to shut down the South Sudanese oil operations (Barber & Xiao, 2012:8; ICG, 2012a:22). The contracts secured the existing consortiums' concessions and the distribution of the shares within the consortiums has remained the same, but some changes have been made to the terms of the EPSAs (ICG, 2012a:21,22). The financial terms of the contracts have been retained, but according to Barber and Xiao (2012:8), stronger environmental regulation, more social protection and more regulations on employment targets of South Sudanese nationals are now part of the contracts. A major change to the terms has given Juba more flexibility in guiding its oil sector policy, by protecting the government from compensating or being held liable to the oil companies in the event of a shutdown of oil production caused by its inability to export oil, such as the confiscation of its oil by Khartoum (ICG, 2012a:22). The impact of this provision on oil corporations has been that they will not be compensated for the losses that resulted from the shutdown of the oil industry since late January 2012 (ICG, 2012a:22). The new contracts also allow the government absolute discretion to extend the contract with oil companies in certain cases (ICG, 2012a:22). For example, the degree of cooperation by the oil companies in helping to resolve the disagreement with Khartoum over its transit fees may allow the government discretion over the extension of the contract (ICG, 2012a:22). ICG (2012a:22) argues that this provision may expose the oil companies to the risk of losses caused by the hostile relations and disputes between the governments of Sudan and South Sudan.

#### **4.2.5 Political risk factor: Company factor**

##### ***4.2.5.1 Company indicator: Nationality of the company***

**Risk rating: Low: 2.** CNPC is one of China's largest NOCs and responsible for most of the oil and gas production in China (CNPC, 2012). As discussed in section 3.2, Chinese NOCs are commercial enterprises that have profit-making goals, but at the same time, have the same status as government ministries and therefore also have to uphold political goals (ICG, 2012a:21). This means that Chinese companies are often willing to take a longer view on investment, as Taylor (2006:942) remarks. For example, Large and Patey (2010:11) comment that oil is often considered a pillar industry for wider business expansion and economic growth, for example the

provision of services connected to the oil industry, that can be more profitable than the actual oil production. Because of this long-term view, Chinese NOCs might ignore short-term losses and be less risk-averse in the short term. A second important advantage of being a Chinese company is Beijing's policy of non-interference, as discussed in section 3.3. For example, CNPC has not been pressurised by Beijing to withdraw from Sudan during the civil war because of human rights abuses as was the case with the Canadian firm, Talisman Energy<sup>77</sup>. Also, the withdrawal of Western enterprises as a result of sanctions due to Sudan's links with terrorism, has opened other business opportunities to Chinese corporations.

#### ***4.2.5.2 Company indicator: World industry positioning***

**Risk rating: Low: 2.** CNPC is an integrated international energy corporation and China's largest oil and gas producer and supplier, with interests in 33 countries (CNPC, 2012). CNPC's business involves upstream and downstream business as well as oilfield services and engineering construction (CNPC, 2012). CNPC owns 86,29 percent of PetroChina, a company listed on the New York, Hong Kong and Shanghai stock exchanges and that ranked 13<sup>th</sup> on the list of the largest oil companies in the world in terms of 2010 oil equivalent reserves (PetroStrategies, 2012). In terms of revenue, CNPC ranked sixth on the 2012 Fortune's Global 500 list after Royal Dutch Shell, Exxon Mobil, BP and Sinopec (CNPC, 2012). Being a major oil producer in China and also worldwide, losses in one project can be offset by high profits in other projects, reducing its relative risk exposure. It should, however, be borne in mind that CNPC is still considerably behind the other large enterprises because of its latecomer status in the global industry.

#### ***4.2.5.3 Company indicator: Special bargaining advantage***

**Risk rating: Nominal: 1.** CNPC firstly has a special bargaining advantage because of its status as a Chinese NOC. This gives the company the advantage of access to low-cost capital and low-cost labour, and the SOEs have relative low return and dividend pay-out requirements (Buckley et al., 2007:513; Mitchell & Lahn, 2007:8). Jiang (2009:602) remarks that Chinese managers, engineers and workers are not expensive and they are also used to working in harsh conditions due to their experience in China's domestic oilfields. This gives the Chinese firms a competitive advantage over Western corporations in the bidding process for projects, as they can, according to Rui (2007:74), offer prices up to a third lower than their Western counterparts.

Secondly, Morck et al. (2008:346) argue that Chinese firms have an advantage over Western firms when operating in countries with a similar institutional environment as China, as

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<sup>77</sup> See section 3.5 for more detail.



Chinese SOEs have developed measures to operate despite government interference<sup>78</sup>. In this regard Buckley et al. (2007:513) comment that ethical considerations are not as relevant for Chinese firms as they are for Western firms when they have to make investment decisions. Rui (2010:75) further remarks that CNPC is effective in mobilising its capabilities in a short period of time and are quick in decision-making. For example, in Sudan CNPC took over the construction of the GNOP project after an affiliate of Petronas could not meet the deadline (Rui, 2010:75).

Thirdly, because CNPC focussed on upstream business before restructuring, CNPC possesses unique, advanced petroleum technologies that supported the Chinese petroleum industry (Rui, 2010:59). For example, Rui (2010:59) points out that CNPC's discovery of the oil in blocks three and seven in the Melut Basin in South Sudan has been successful because of Chinese domestically developed technologies to discover oil in passive rift and under-explored basins. This technology may give CNPC the advantage of more successful exploration activities.

Fourthly, as a SOE, CNPC has the advantage of diplomatic and economic support from the Chinese government. For example, in February 2011, China's vice foreign minister, Zhang Zhijun, accompanied by a senior CNPC executive, visited Juba to seek assurance from Juba of the security of the CNPC's oil investments, in addition to its diplomatic goals (ICG, 2012a:6). ICG (2012a:28) also reports that during December 2011, when South Sudanese oil was confiscated by Khartoum, the Chinese Special Envoy for African Affairs, Liu Guijin, was summoned to Juba for diplomatic intervention. Furthermore, during a visit from Li Yuanchao, a senior CPC figure, in January 2012, the possibility of a Chinese economic cooperation package was discussed and aid of US\$31,5 million for 2012 was pledged (ICG, 2012a:10). Barber and Xiao (2012:6) report that the Chinese government and China Exim Bank have expressed their willingness to provide concessional loans for the development of infrastructure projects, which would be constructed by Chinese companies. This Chinese diplomatic involvement and willingness to engage with South Sudan in terms of loans, aid and economic cooperation, gives CNPC a special bargaining advantage.

A fifth advantage for CNPC is China's trade relations with South Sudan. Sixty six percent of combined Sudanese-South Sudanese exports in 2011 were destined for China, whose refineries are equipped to refine the Dar blend crude produced in the Melut Basin (EIA, 2012). This dependency on China for South Sudanese exports makes CNPC less vulnerable to being targeted by the government of South Sudan.

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<sup>78</sup> Jacobs (2011:54) has a similar argument that transnational corporations (TNCs) from developing countries have an advantage when they operate in countries with difficult governance conditions, because they have the same institutional conditions at home.



Lastly, it should be noted that CNPC has the advantage of being the first and also the largest investor in Sudan (Jiang, 2009:598) and after independence, also in South Sudan. Because of South Sudan's extreme dependency on oil revenue, the government could not afford to cease the contracts with CNPC, as it would cripple the South Sudanese oil industry (ICG, 2012a:22). ICG (2012a:22) also argues that if Juba ignored the existing contracts with CNPC and considered new tenders, the government's reputation as an investment destination for Western companies would be ruined. This gave CNPC an extreme bargaining advantage despite negative sentiments towards the corporations amongst many SPLM officials. Because of the mutual interest, South Sudan was obliged to secure CNPC's investment by renewing the oil contracts.

#### ***4.2.5.4 Company indicator: Host government relations***

**Risk rating: Extreme: 5.** Due to CNPC's central role in the development of the Sudanese oil industry and the role of oil in the civil war<sup>79</sup>, historically the SPLM did not have a good relationship with CNPC. The oil corporations have been associated with the brutalities of the civil war and complicity with the NCP and Khartoum (Barber & Xiao, 2012:8; ICG, 2012a:2). During the interim period of the CPA since 2005, when CNPC started production in the Melut Basin, Khartoum was still in charge of the oil industry. Southern Sudan's relations with CNPC were still strained because CNPC was suspected of complicity with Khartoum in manipulating oil production figures to Southern Sudan's disadvantage<sup>80</sup> (Barber & Xiao, 2012:8). With the signing of new contracts after independence, ICG (2012a:22) remarks that some in the SPLM still had negative sentiments towards CNPC and would rather replace their contracts with Western firms. As mentioned in section 4.2.5.3, contracts were renewed in January 2012 with CNPC because of pragmatism and mutual interest and not because of good government relations with CNPC. According to Barber and Xiao (2012:8), Juba was of the opinion that the oil companies could do more to resolve the dispute over the transit fees by putting more pressure on Khartoum.

The relations between CNPC and the government of South Sudan were strained further by the expulsion of the Chinese head of Petrodar from South Sudan in February 2012 after being accused of complicity with Khartoum (ICG, 2012a:30, Sudan Tribune, 2012). CNPC faces the dilemma of having significant investments in both Sudan and South Sudan that have to be protected (BMI, 2012d). Strained relations between Juba and Khartoum have put CNPC in a difficult position because of Juba's historical association of CNPC with Khartoum, which may pose a threat to CNPC of being targeted by Juba's decisions.

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<sup>79</sup> For more details refer to section 3.6.

<sup>80</sup> During the CPA period, Southern Sudan shared in 50 percent of oil revenue from its territory.

#### 4.2.6 Political risk factor: International factor

##### 4.2.6.1 International indicator: *Host government international integration*

**Risk rating: Medium: 3.** Since independence, South Sudan has appointed 90 ambassadors and joined the WB, IMF and FOCAC (UNSC, 2012b:1; ICG, 2012a:4). Despite the fact that the US maintained good relations with the SPLM, Southern Sudan has still been isolated because of US sanctions against Sudan (Dagne, 2011:7). Since independence the US sanctions have been lifted and the US has increased the number of officials in South Sudan (Dagne, 2011:7; BMI, 2012f:39). However, because of the dominance of the Asian countries in terms of investments and trade, South Sudan has not been integrated on a global level. This lack of competition from Western firms currently gives CNPC a competitive advantage in South Sudan.

In terms of regional integration, Dagne (2011:7) comments that the SPLM has always maintained good relations with East African countries such as Ethiopia, Kenya, Tanzania and Uganda, and South Sudan has started to integrate into regional organisations such as the East African Community (EAC), Intergovernmental Authority on Development (IGAD) and the Common Market for Eastern and Southern Africa (COMESA)<sup>81</sup> (UNSC, 2012b:5; African Economic Outlook, 2012:4; BMI, 2012h:61). However, South Sudanese trade with neighbouring countries have been limited because of the lack of infrastructure and economic activity other than oil production and Lacher (2012:8) argues that the South Sudanese economy has only been superficially integrated into markets and monetised exchange. Therefore, South Sudan's economy remains dependent on the oil industry and CNPC's investment.

##### 4.2.6.2 International indicator: *Host/home government relations*

**Risk rating: High: 4.** As a Chinese NOC, CNPC may be affected by the relationship between the Chinese and South Sudanese government. After exclusively dealing with Khartoum during the civil war, Beijing started to cultivate relations with Juba after the 2005 CPA, but at the same time strengthened its ties with Khartoum (Large & Patey, 2010:5). Since South Sudan's independence, Beijing still has to find a balance in its relationship with both countries. As ICG (2012a:i) argues, it has proven difficult because of the unresolved political, economic and security issues that fuelled hostile relations between Juba and Khartoum since independence. Martina (2012) points out that China's oil investments in both countries have given the Chinese government a stake in preserving stability between the two countries. Also, trade relations with South Sudan is still important for China as approximately five percent of China's oil imports come from South Sudan (BMI, 2012f:19). The Chinese government aims to support peace by

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<sup>81</sup> The membership of these organisations is not necessarily a sign of regional integration, as these organisations with overlapping membership compete with one another.

focussing on economic development to overcome the “structural sources of the conflict” (Large (2012:5,12), and the government have indicated that they would support South Sudan in key areas such as energy, infrastructure, telecommunications and agriculture (ICG, 2012a:4).

Because of Beijing’s close relations with Khartoum during the civil war, the Chinese government and Chinese business firms, in particular CNPC, have been associated with the economic exploitation and marginalisation of the south, while Khartoum has been favoured with regards to development (Wheeler, 2012:10). It seems as if this negative sentiments remains a hurdle in Sino-South Sudanese relations (Wheeler, 2012:10) and may affect the South Sudanese government’s sentiments towards CNPC. However, Barber and Xiao (2012:6) remark that Juba sees the potential benefits that China’s engagement might bring, particularly in addressing the country’s large infrastructure deficit. Sautman and Yan (2009:756) as well as Kuo (2012:4) argue that large construction projects around Juba by Chinese firms since the CPA in 2005 have influenced South Sudanese perceptions toward China positively. According to ICG (2012a:8), the South Sudanese perception has also changed because the Chinese government appears more willing to listen to the needs of the South Sudanese than their Western counterparts. Furthermore, while Beijing’s policy of “non-interference” was criticised during the civil war, Large (2012:19) and Barber and Xiao (2012:6) remark that this policy now appears to appeal to the government of South Sudan.

Beijing has strengthened its ties with Juba though various high-level political visits to South Sudan, and President Salva Kiir has also visited Beijing since South Sudanese independence. Beijing has shown its willingness to support South Sudan by way of concessional loans, the construction of sports facilities and the renovation the Juba airport, as well as in areas such as humanitarian aid and the provision of anti-malaria drugs (Barber & Xiao, 2012:6). By way of its involvement in the peacekeeping mission by contributing troops to UNMISS, the Chinese government also supports security issues (ICG, 2012a:14).

Despite this closer economic cooperation, ICG (2012a:29) points out that the dispute over transit fees with Khartoum has strained Juba’s relations with Beijing that may affect Juba’s sentiments towards CNPC. Beijing’s reluctance to get more involved in finding a solution to the oil dispute has been criticised by Juba and the international community. The Chinese government’s inaction against Khartoum after the confiscation of South Sudanese oil in December 2011 and January 2012 was seen by Juba as “passive complicity” with Khartoum (ICG, 2012a:ii). According to ICG (2012a:27), one of the main reasons for Beijing’s reluctance to press Khartoum is that it would be expected from China to write off Sudan’s debt of at least US\$1,9 billion to make up for the gap in Sudanese lost oil revenue. Although high-level visits have been made to Juba to try to influence the parties, Kuo (2012:4) remarks that South Sudan is

not a top priority to China. This reluctance to get more involved in the oil dispute has had a negative effect on the relationship between Juba and Beijing, and consequently may affect Juba's relationship with CNPC.

#### ***4.2.6.3 International indicator: World petroleum market***

**Risk rating: Medium: 3.** The supply of oil on the world petroleum market has been limited by US and European Union (EU) bans to import oil from Iran and Syria, and oil prices remain high<sup>82</sup> (UN, 2012:4,12). Other key exporters such as Saudi Arabia have since increased their production to satisfy global demand and to ensure more stable prices (IMF, 2012:6). Apart from the Eurozone, BMI (2012a:5) expects global oil consumption to increase, because the economy of China, now the second largest oil consumer in the world, is still expected to grow at seven and a half percent in 2012 (BMI, 2012g:29). According to Ma et al. (2012:47), China has imported more than 50 percent of its oil supply since 2009 and this trade accounts for ten percent of the global oil trade. However, BMI (2012a:9) points out that the Chinese oil demand might decline if Beijing moves towards a market-based pricing system for fuel. But CNPC can still rely on the Chinese market because of the demand for the South Sudanese oil blends (BMI, 2012h:46).

#### ***4.2.6.4 International indicator: World economic condition***

**Risk rating: High: 4.** The world economic condition remains weak and while world economic growth for 2011 was only 2,7 percent, the UN (2012:1) expects world growth of 2,5 percent in 2012 and 3,1 percent in 2013. According to the UN (2012:1) the sovereign debt crisis in the Eurozone remains the biggest threat to the world economy, because an escalation of the crisis can trigger turmoil in the financial markets that in turn can lead to the contraction of economic activity in developed countries, that is already strained. The IMF (2012:4) argues that the declining demand in developed countries puts strain on developing countries' growth, as evidenced by the slower growth of emerging market countries such as Brazil, China and India. The IMF (2012:4) also comments that low-income countries receive less aid because of declining economic growth in developed countries. The weak world economic situation can firstly affect CNPC because of lower oil demand that may lead to a lower return on investment. Secondly, it may be expected from CNPC to contribute more towards South Sudanese development as the weak financial situations of developed countries can limit their aid contributions to South Sudan. Especially since the shutdown of the oil production, South Sudan is dependent on donors for the building of infrastructure, that is in turn needed for South Sudanese economic growth.

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<sup>82</sup> Refer to section 4.2.4.7.

#### 4.2.6.5 International indicator: *The demonstration effect*<sup>83</sup>

**Risk rating: High: 4.** ICG (2012b) reported in May 2012 that the Sudanese government has been extremely concerned about the effect that the Arab Spring<sup>84</sup> uprisings in North Africa and the Middle East since December 2010 could have on Sudan. Reeves (2012) reports that there have been unprecedented protests due to grievances of hyperinflation and high fuel prices during June and July 2012 around Khartoum that also spread to other Sudanese regions. Because of the demonstration effect, these protests may also spill over to South Sudan, which has the same economic problems as Sudan. Such protests may threaten the security of CNPC's personnel and assets. Furthermore, regime change in Sudan might affect the peace between Juba and Khartoum, a critical component of CNPC's investment security in South Sudan because of their economic interdependency in terms of oil exports.

### 4.3 Calculation of overall political risk

In this section, the risk ratings for the indicators as scored in section 4.2 are applied to the Boshoff (2010) political risk model, as set out in section 2.4. A weight should be attached to each risk factor according to "the impact that the factor has relative to the analysis and the other factors" (Boshoff, 2010:60). The impact of the factors that contribute towards host country political risk is regarded as having a larger impact than the country and international risk factors. A combined weight of 70 percent for the four host country political risk factors and 30 percent for the combined company and international factors was regarded as the relative importance of the factors in the analysis. Because of the major impact of the oil industry in South Sudan's political, economic and societal sphere, and the interconnectedness of these factors, even weights of 17,5 percent are attached to the political, economic, societal and petroleum factors. As the company and international risk factors are also interconnected in the sense that international indicators influence company indicators<sup>85</sup>, these two factors were regarded as having an equal impact on the analysis, and therefore a 15 percent weight is attached to each of these two factors.

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<sup>83</sup> The demonstration effect refers the fact that developments in one place will often act as a catalyst for the same developments in another place.

<sup>84</sup> Oxford Dictionaries (2012) define "Arab Spring" as a series of anti-government uprising in various countries in North Africa and the Middle East, beginning in Tunisia in December 2010. The uprisings have spread to Egypt, Libya and Syria.

<sup>85</sup> For example, the international risk indicator of the relationship between the governments of China and South Sudan influences the relationship between CNPC and South Sudan, a company risk indicator.

Political risk type	Factors	Indicators	Reference	Rating 0-5	Weight	Score
Host country political risk	Political  <i>Average rating: 3,5<sup>86</sup></i>	Regime/political stability	4.2.1.1	5	17,5%	12,25
		War and security issues	4.2.1.2	4		
		Repatriation restrictions	4.2.1.3	2		
		Corruption/ poor governance	4.2.1.4	4		
		Unclear legislation/security of tenure	4.2.1.5	3		
		Investment constraints	4.2.1.6	3		
	Economic  <i>Average rating: 4,14</i>	Economic performance	4.2.2.1	4	17,5%	14,5
		Balance of payments	4.2.2.2	4		
		Creditworthiness	4.2.2.3	4		
		Currency convertibility	4.2.2.4	3		
		Energy vulnerability	4.2.2.5	5		
		Public/private sector mix	4.2.2.6	5		
	Current account deficit	4.2.2.7	4			
	Societal  <i>Average rating: 4</i>	Internal violence	4.2.3.1	4	17,5%	14
		Civil and labour unrest	4.2.3.2	4		
		Homogeneity	4.2.3.3	4		
		Ethnic conflict	4.2.3.4	4		
		Community opposition	4.2.3.5	4		
		Standard of living	4.2.3.6	5		
Environmental activism		4.2.3.7	3			
Petroleum  <i>Average rating: 3,11</i>	Ownership	4.2.4.1	5	17,5%	10,89	
	Domestic reserves and production	4.2.4.2	4			
	Host’s relative market position	4.2.4.3	3			
	Level and destination of exports	4.2.4.4	4			
	Strength of national oil company	4.2.4.5	2			
	Role of foreign company in industry	4.2.4.6	2			
	Oil and gas prices	4.2.4.7	2			
	Domestic ability to operate the industry	4.2.4.8	1			
	Firm and host contractual relationship	4.2.4.9	5			
Company political risk	Company  <i>Average rating: 2,5</i>	Nationality of the company	4.2.5.1	2	15%	7,5
		World industry positioning	4.2.5.2	2		
		Special bargaining advantage	4.2.5.3	1		
		Host government relations	4.2.5.4	5		
International political risk	International  <i>Average rating: 3,6</i>	Host government international integration	4.2.6.1	3	15%	10,8
		Host/home government relations	4.2.6.2	4		
		World petroleum market	4.2.6.3	3		
		World economic condition	4.2.6.4	4		
		The demonstration effect	4.2.6.5	4		
Total						69,94

**Table Three:** Calculation of overall political risk for CNPC in South Sudan.

<sup>86</sup> This rating of 3,5 reflects the average risk rating for the indicators of the political risk factor. This figure is calculated by adding all the risk ratings of the indicators for this factor and dividing the sum by the number of indicators. For example:  $(5+4+2+4+3+3) \div 6 = 3,5$ .

The average risk rating for the political factor is 3,5. While the risk ratings for the indicators of political instability, war and security issues and corruption were high to extreme, the average rating for the political factor has been reduced by the fact that there is a low risk for restriction on repatriation of funds or personnel, and medium risk for the indicators of unclear legislation and investment constraints.

The average risk rating for the economic factor is high at 4,14. While most of the indicators are high to extreme risk because of the effect of the oil shutdown on the economy, the average has been slightly reduced by the indicator of currency convertibility, because oil is traded in foreign currency.

The average risk rating for the societal factor is high at 4. Internal violence may affect the oil producing regions of South Sudan, and poor living standards, ethnic divisions and unequal development may pose a risk of civil and labour unrest or environmental activism.

The petroleum factor is rated at an average risk of 3,11. While the indicators such as the South Sudanese state ownership of the oil reserves, declining oil reserves and the dependency on neighbouring countries' infrastructure for oil exports may pose a high risk, the risk is mitigated by the fact that South Sudan is extremely dependent on CNPC for the operation of its oilfields.

The average risk rating for the company factor is relatively low at 2,5. Despite the fact that an extreme risk rating is assigned to the strained relations between Juba and CNPC, the risk is mitigated because of the special bargaining power of CNPC, such as the importance of China in terms of South Sudanese oil trade, CNPC's status as a Chinese SOE, its technical and managerial capabilities and experience, and being the first and largest investor in the country.

The average rating for the international factor is 3,6, because of strained relations between the governments of South Sudan and China, the weak world economic condition and the risk of the spill-over to Juba of civil unrest in Khartoum following the Arab Spring uprisings.

From the analysis it can be seen that while the political, economic, societal and international factors have been rated high, the overall risk has been reduced because of the petroleum factor and the company factor. According to the scale for investment and political risk indication<sup>87</sup>, a score of 69,94 gives an investment indication of moderate to high risk and a political risk indication of high. This means that although CNPC may be exposed to high risk in the South Sudanese oil industry, it is still not at a level where the firm is advised to leave the country. While other oil firms may be reluctant to enter the country due to the high risk involved, CNPC's competitive advantage may provide the firm with opportunities to gain from the high-risk situation. The overall political risk rating will be explained in the next section.

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<sup>87</sup> Refer to section 2.4, Table Two.



#### 4.4 Overall political risk evaluation

With the transfer of 75 percent of Sudan's oil operations to South Sudan at independence, CNPC faced the risk that Juba would not renew its contracts to continue the oil production of the concessions that GNPOC and Petrodar had in Sudan. Negative sentiments towards the Chinese government and CNPC due to their association with Khartoum indicated an extreme risk rating.<sup>88</sup> However, the risk has been reduced by the fact that the SPLM rather acted pragmatically in its decision to continue the contracts with CNPC. Because of South Sudan's extreme reliance on oil revenue, the government could not afford to terminate the contracts with CNPC because it would send out a negative message as to the security of investments in South Sudan to other possible investors, making it difficult for Juba to replace CNPC as an investor.

Also, the oil industry would be crippled if Juba terminated the contract with CNPC. Juba is extremely reliant on the oil revenue and does not have the ability to operate the oil industry without GNPOC and Petrodar. Because of the important role that CNPC played in the operation of the oil industry, such as the exploration technologies used in the Melut Basin and the development of the oil infrastructure, Juba is extremely reliant on CNPC to produce oil. Furthermore, CNPC has an advantage because of its status as a Chinese SOE. South Sudan's economy is extremely dependent on China as an export destination as most of China's refineries can process South Sudanese oil, while US refineries are not adequately equipped. These economic relations between South Sudan, China and CNPC impacted positively on the risk that CNPC's operational contracts would be terminated with South Sudanese independence. CNPC signed a five-year transitional contract with Juba in January 2012, thereby securing its operations over the short term. However, despite the fact that CNPC can now be assured of the continuation of its operations, the terms of the contract may still pose a high risk to CNPC. Although the contract secured the existing concessions for CNPC, the contract allows for flexibility in Juba's actions in cases where South Sudan is unable to export its oil. This allowed for the decision by Juba to shut down its oil production in late January 2012 without having the liability to compensate the oil corporations. This oil shutdown has led to severe losses for CNPC's operations in South Sudan during 2012.

The hostile relationship between Khartoum and Juba is another major factor of risk that might threaten the security of CNPC's investments in South Sudan since the country's independence. Because of the economic interdependence of the two countries, the hostile relationship and disagreement on an acceptable oil deal after independence has resulted in the shutdown of the South Sudanese oil production since late January 2012, and production is only expected to resume after a final peace agreement has been signed, which is to be negotiated

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<sup>88</sup> Refer to sections 4.2.5.4. and 4.2.6.2.

during September 2012 under the facilitation of the AUHIP. The shutdown has caused severe direct losses to CNPC, as Juba is not liable for compensating the oil companies in accordance with new contracts signed in January 2012. The shutdown has also indirectly affected CNPC, firstly because of the deteriorating effect that it had on relations between CNPC and Juba, as well as on Beijing-Juba relations. Secondly, the Sudanese and the South Sudanese economies have been devastated by the loss of oil revenue since the shutdown. This may pose the risk to CNPC of being targeted by the government to make up for the loss of oil revenue. The devastated economy in both countries has further major negative consequences for economic and human development in South Sudan that in turn may fuel grievances amongst the population. While protests have already started in Khartoum, there is a risk that it may spill over to South Sudan, a country with a violent political culture. This may also result in the renewal of violent conflict between Sudan and South Sudan, as evidenced by the interstate conflict in April 2012. The escalation of violence in both countries may affect the security of CNPC's oil facilities and its ability to export oil through Sudan. As CNPC's investments are dependent on South Sudan's ability to export its oil, any renewed conflict may affect this ability. Therefore, the security of CNPC's investment is dependent on the successful implementation of the peace agreement that is currently negotiated between Juba and Khartoum. The dependence of both economies on the revenue from the oil industry gives both parties an incentive to reach a deal, as both economies cannot afford further losses.

#### **4.5 Conclusion**

The purpose of this chapter was to answer the second sub-question of the study, which asks what the level of political risk is that CNPC faces in South Sudan since the country's independence on 9 July 2011. A political risk analysis was performed in accordance with Boshoff's (2010) model and a score of 69,94 was calculated as an overall political risk level that CNPC faces in South Sudan. According to the scale, this indicates that CNPC has an investment indication of moderate to high risk and a political risk indication of high. This means that CNPC may face high political risk when operating in South Sudan, but the risk is still at an acceptable level for investment. A rating above 81 would be an indication that the investment is inadvisable. Despite the high risk, CNPC may still have opportunities for high investment returns in the country's oil industry if the firm uses its competitive advantage and manage the political risk.

In the next chapter, the results of the political risk analysis will be examined in order to answer the main research question and the study will be evaluated in accordance with the meeting of the research objectives.

## Chapter Five: Conclusion and evaluation

### 5.1 Introduction

China has increased its FDI outflows to Africa significantly over the last decade and the African oil and gas industry in particular provides investment opportunities for Chinese NOCs. However, these opportunities are often in countries associated with high political risk, making the analysis of political risk increasingly relevant for the investment decision-making process of Chinese corporations as changes in political dynamics can affect the opportunities and profitability of investments. The nature of political risk has become complex as the world economies are increasingly integrated and interconnected and it has become important for firms to identify and incorporate all the dimensions of political risk into the analysis. As various scholars<sup>89</sup> have argued that political risks are specific to certain industries, firms or projects, the objective of the study was to demonstrate the importance of firm-specific political risk analysis by way of a case study. The study aimed to identify the main indicators of political risk that Chinese firms may face in the oil and gas industry in African countries. A qualitative research approach was followed by way of an empirical case study of the political risk faced by one of China's NOCs, CNPC in South Sudan.

This last chapter brings the study to a conclusion by firstly providing a brief outline of the progress of the study up to this point. Thereafter, the study is evaluated in light of the main research question and the objectives as set out in Chapter One. This is followed by recommendations for future research in the field of political risk analysis.

### 5.2 Progress of the study

Chapter One served as a general introduction to the study. The research problem and research questions were presented, as well as the objectives, rationale and significance of the study. The objective was to gain an understanding of the political risks that Chinese firms may face in the African oil and gas industry and to demonstrate the importance of firm-specific political risk analysis in accordance with the general theories of political risk. The research design and research methods have been outlined, followed by an overview of the main literature that would be used during the course of the study. Thereafter the limitations and delimitations were set out, and finally, an outline of the further chapters was presented.

Chapter Two firstly provided a theoretical grounding for the study by a discussion of political risk analysis in connection with decision-making and problem-solving theory. Secondly,

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<sup>89</sup> Refer to scholars such as Boddewyn and Brewer (1994), Frynas and Mellahi (2003), Brink (2004), Alon and Herbert (2009) and Boshoff (2010).

the chapter served to conceptualise key terminology that would be used and applied during the course of the study. The concepts clarified included the terms FDI, risk, political risk, country risk, political instability, macro and micro political risk and political risk analysis. In the last section of the chapter the political risk model that would be used in the case study as a framework for the analysis of political risk faced by CNPC in South Sudan was presented.

Chapter Three contextualised Chinese investments in the African oil and gas industry and its role in the Sudanese oil industry before South Sudan's independence. Firstly, the influence of the Chinese foreign policy in relation to Chinese FDI was discussed, with special reference to the role of the state in the investment decisions of SOEs. It was found that the state's control over the investment decisions of Chinese SOEs has weakened over the last decade because of bureaucratic fragmentation. Secondly, the influence of Chinese foreign policy on outflows of FDI to Africa was discussed, followed by a focus on Chinese investments in the African oil and gas industry. To narrow the context down to the current situation in South Sudan, the role of CNPC in the development of the Sudanese oil industry was discussed, followed by a brief discussion of the key issues of the Sudanese civil war that might impact the analysis of political risk faced by CNPC in South Sudan. The main issues of concern following the secession of South Sudan from Sudan on 9 July 2011 were then outlined. The two countries still had to agree on how to share the oil revenue and Sudan's external debt. Also, no agreements have been reached on the demarcation of the common border and the status of citizens living across the border. The chapter concluded with the answering of the first sub-question of the study, which asked to identify the features of the relationship between China and Sudan before South Sudan's secession. The features identified were broadly: Chinese oil firms engaged with Sudan as part of Beijing's "going out" policy; Beijing's policy of "non-interference"; China's economic interest in Sudan's oil; CNPC's as largest oil investor; and the Chinese government and SOEs' relations with Khartoum during the Sudanese civil war.

The purpose of Chapter Four was to answer the second sub-question, which asked what the level of political risk is that CNPC faces in South Sudan since the country's independence. An analysis of the political risk was presented by applying Boshoff's (2010) political risk model for the oil and gas industry to the specific case. Each of the six political risk factors identified in the model were rated in accordance with the analysis and the rating of the specific risk indicators for each risk factor. The overall political risk level of 69,94 percent was calculated in accordance with the model's mathematical formula, which indicated that CNPC has a high level of political risk exposure in South Sudan. However, the risk is not at a level where the firm would be advised to leave the country. CNPC may still have opportunities to gain from the high-risk situation

because of its competitive advantage in the country as an established investor in the South Sudanese oil industry.

### 5.3 Evaluation of the study

#### 5.3.1 *Answering the main research question*

The objective of the study was to demonstrate the general theories of political risk and the importance of firm-specific political risk analysis for Chinese firms operating in the oil and gas industry in Africa, as firms may be influenced in different ways by the political environment of countries in which they operate. If Chinese firms only focus on the analysis of macro political risk when operating in African countries with high-risk political environments and not take micro political risk factors that may mitigate the risk into account, important investment opportunities might be missed. The purpose of the study was not to develop a political risk model for Chinese oil firms, but to gain more empirical knowledge on the political risk they may face by way of a case study. As Yin (2009:14,15) points out, the findings from a case study cannot be generalised to populations or universes, but can be generalised to theoretical propositions with the goal of expanding or contributing to general theories. The research question of the study was: what are the main indicators of political risk that Chinese corporations may face in the oil and gas industry in African countries?

In order to answer the main research question, the analysis of political risk faced by CNPC in South Sudan as set out in Chapter Four, has been examined and generalised to the theories of political risk as discussed in Chapter Two. The following main indicators<sup>90</sup> of political risk that Chinese corporations may face in the oil and gas industry in African countries have been identified<sup>91</sup> in this study, which includes indicators of macro as well as micro political risk.

- **Political instability.** Political instability in African countries may expose Chinese oil firms to the risk of decisions made by new governments or new factions within the government, which might impact the firm's ability to continue its operations or influence its profitability. This was demonstrated in the case study by the decision of the South Sudanese government to shut down the oil production of the country, following a dispute with Sudan over the fees charged for the use of Sudan's oil infrastructure.
- **International and internal conflict.** Violent conflict, whether international or internal, may expose Chinese firms to security risks if their operations are situated in the conflict

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<sup>90</sup> The term indicator is used in the same context as used in the Boshoff (2010) political risk model. In other studies these indicators may be referred to as risk factors.

<sup>91</sup> The list only includes the indicators of political risk that were identified in the study. Other factors and indicators may affect the political risk for Chinese NOCs operating in African countries that were not identified in the case study.

zones. Oil fields, the production facilities and the transport and export infrastructure may be damaged, and the security of oil firms' personnel may be threatened by violent attacks during a conflict situation. In situations where the African country is dependent on infrastructure of neighbouring countries to export its oil, violent conflict in those countries may also influence the political risk exposure of Chinese firms. In South Sudan, violent conflict between Sudan and South Sudan has threatened the security of oil fields that have specifically been targeted by armed forces of both sides. CNPC's oil production facilities are also situated in the Sudan-South Sudan border zones, where incidences of internal violence were widespread since 2011. Furthermore, ongoing internal violence in the Sudanese states of Southern Kordofan and Blue Nile may expose CNPC to political risk, as attacks on the oil pipelines to Port Sudan may influence South Sudan's ability to export its oil.

- **Corruption and weak state institutions.** Corruption and a system of patronage is a political risk variable that may affect Chinese oil firms as it sustains weak administrative systems in African countries. Corruption may be particularly high in countries where the economy is very dependent on oil revenue. This makes the firms extremely reliant and vulnerable to individuals in the government or state institutions of African countries. This might especially be a problem in countries with unstable governments where individuals are easily substituted.
- **Economic development.** The African country's economic development may indirectly affect the Chinese oil corporations' investments. Poor economic development outside the oil industry and unequal distribution of the benefits of oil revenue may cause grievances amongst the population that in turn may trigger violent conflict or political instability. In the case study, this was evidenced by the effect that the marginalisation of southern Sudan in terms of economic development had on the outbreak of the Sudanese civil war. Grievances amongst South Sudanese government officials towards Khartoum due to the unequal distribution of oil revenue were also one of the main reasons for the decision to shut down the South Sudanese oil production at the beginning of 2012.
- **Social development.** Poor human development levels in African countries may pose the risk of operational inefficiency to Chinese oil corporations, especially if the African country has strict local employment policies. Chinese oil firms may also be indirectly affected by poor social conditions, which may increase the risk of civil and labour unrest, political instability or internal violence.
- **Community opposition.** Chinese oil corporations may be exposed to the risk of being targeted physically or by way of activism because of community opposition against the oil

firms. For example, Chinese oil companies in South Sudan are negatively associated with alleged forced removals during the development of the Sudanese oil fields. Furthermore, Chinese oil companies in South Sudan have been accused of following a top-down approach in social development projects in the oil producing regions, and of being reluctant to assist in aiding to resolve the humanitarian crisis in the country.

- **External dependency of the oil industry.** The more dependent the African country is on its neighbouring or other countries for the export of its oil, the more vulnerable the Chinese oil firms may be to possible hostile relations with neighbours or conflict in neighbouring countries that can jeopardise the host country's ability to export its oil. In the case study, this was demonstrated by the dispute over the oil transit fees that Sudan charged for the use of its oil pipelines to Port Sudan. The landlocked South Sudan is completely dependent on Sudan to export its oil and the dispute influenced its ability to export oil that in turn led to the decision by Juba to shut down the oil production.
- **Location of the oil operations.** The political risk exposure of the Chinese oil firms may be influenced by the location of the oil fields. In the case of South Sudan, all the oil fields operated by GNPOC and Petrodar, as well as the oil pipelines that transport the oil to the export facilities, are located in regions where they may be exposed to violent conflict. However, the head offices of the oil consortiums are situated in Juba, where the security situation is more stable and the administration personnel and assets may be less exposed to political risk.
- **Contract specifications.** The specifications of contracts that Chinese oil corporations have with the African countries may make the firms vulnerable to political decisions taken by governments. In the case of South Sudan, oil companies only have a right to operate the oil fields in terms of EPSAs, which grant certain rights to the South Sudanese government and may expose the firms to political risk. For example, in terms of the contract between CNPC and the South Sudanese government, CNPC does not have a right to be compensated by the government for the losses incurred by the government's decision to shut down the oil production.
- **Relative importance of the Chinese NOC to the host country's oil industry.** The more dependent the country is on the Chinese firm to operate the oil industry, the less the firm may be exposed to the risk of expropriation. This is especially the case when the country does not have the ability to operate the industry. In the case of South Sudan, CNPC is the largest investor in the oil industry and the country is extremely dependent on the oil consortiums run by CNPC to operate the industry. As a new state, the South Sudan has weak state institutions and a weak NOC with little experience in the field of petroleum



policies. CNPC is important as most of the Western oil firms have left the country because of the Sudanese civil war and sanctions against Sudan since the late 1990s.

- **Competitive advantage of Chinese NOCs.** Being a Chinese SOE may give a firm a special competitive advantage over other firms operating in the African oil and gas industry. Firstly, Chinese SOEs traditionally had a long-term perspective on the expansion of business opportunities rather than short-term profits. Managers of SOEs are now more profit-oriented, but may still have a longer term view on profits than firms from other countries and may still be influenced by political goals. Secondly, because of Beijing's official policy of "non-interference", Chinese SOEs may have opportunities to expand their business operations in countries where Western firms have withdrawn for political reasons. Generally Chinese SOEs do not have the same pressure from their home country as Western firms have to withdraw their investments from a country for political reasons such as terrorism or human rights violations. This was demonstrated in the case study by the fact that CNPC got a foothold in Sudan because of a lack of Western competition. US firms were prohibited by sanctions to invest in or trade with Sudan because of alleged terrorism. Thirdly, Chinese SOEs may have a special bargaining advantage of low-cost capital and labour, and low investment return and dividend payout requirements. This may give Chinese firms the advantage of being able to bid lower than their Western counterparts for oil operating contracts or construction projects in the oil industry. Fourthly, Chinese SOEs' ability to make quick decisions and mobilise its activities in a short period may contribute to its competitive advantage. Indeed Frynas and Mellahi (2003) suggest that firms may exploit their competitive advantage and use it to reduce their political risk exposure. Chinese NOCs may therefore use these attributes of being a SOE to gain opportunities in the African oil and gas industry.
- **Government support to Chinese NOCs.** Chinese NOCs may have the advantage of diplomatic and economic support from the Chinese government, mainly in the form of economic cooperation packages. Sethi and Luther (1986:66) argue that such a relationship may safeguard firms against some aspects of risks, for example if the home government can pressure the host government by withholding aid. The availability of these economic cooperation packages may secure Chinese oil firms' access to exploration concessions in African countries. MOFCOM oversees Chinese FDI and aid, and can provide concessional loans to African countries for the development of infrastructure through China Exim Bank. These loans are attractive to African countries as they have relatively low interest rates and no political conditions such as good governance or the adherence to human rights regulations are attached to the loans. The availability of these loans may

benefit Chinese oil firms as the repayment of the loans may be linked to Chinese access to the African oil fields, either in the form of concessions or in the form of oil exports to China.

- **Technical abilities of Chinese NOCs.** The technical abilities of Chinese oil firms may influence their political risk exposure positively or negatively. As demonstrated in the case study, CNPC had a technical advantage in the exploration of the Melut Basin in Sudan because of its experience in the Chinese upstream oil industry. This technical ability made Sudan, and later South Sudan, extremely dependent on CNPC and thereby reduced the firm's risk exposure of being expropriated. However, in concessions that involve offshore exploration, CNPC may have a disadvantage because of a lack of technological experience.
- **Relative size of the Chinese NOC and the investment.** The world industry positioning of the Chinese oil firm and the relative size of the investment for the firm may affect the firm's political risk exposure. Large firms such as CNPC and Sinopec with wide investment exposure may be able to offset their losses of one project or investment by high profits gained in other projects or investments. In the case of South Sudan it was found that CNPC had the ability to carry the losses incurred during the shutdown of the South Sudanese oil production.
- **Economic dependency on the Chinese NOC.** The relationship between the Chinese firm and the African country may have a significant influence on an oil firm's political risk exposure, in particular its economic relationship. The more economically dependent the country is firstly on the oil industry, and secondly on the Chinese oil firm, the less political risk the firm may be exposed to. It was found in the case study that the relations between CNPC and South Sudan were strained because of CNPC's association with Khartoum during the civil war. However, despite negative sentiments in the SPLM government towards Chinese oil firms that could lead to their contracts being ceased, the South Sudanese government acted pragmatically by renewing the contracts with CNPC because of economic interest. Due to South Sudan's extreme dependency on the oil industry, and on CNPC as the largest investor with established oil production facilities in the country, the termination of their contracts would cripple the South Sudanese oil industry and with it the South Sudanese economy. Rather than acting on political sentiments, economic interest was decisive in Juba's relations with CNPC.
- **China's economic relations with the host country.** The more the host country's economy is dependent on China for trade, investments or finance for development projects such as infrastructure, the less political risk exposure the Chinese oil firm may

face. Also, the more important the host country is for China in economic terms, the more the firm may depend on support from the Chinese government, that may assist the firm to mitigate its political risk exposure. Sethi and Luther (1986:63) argue that a firm may use the relations between the home and host country as a bargaining power. In the case study the political and diplomatic relations between the governments of China and South Sudan were strained because of Beijing's close relations with Khartoum and the Chinese government's reluctance to get involved in the resolution to the oil dispute. However, the economic relations between the two countries were more important and played a larger role in the mitigation of CNPC's political risk exposure in South Sudan. China is of major economic significance for South Sudan as the largest source of FDI, the largest export destination and a large potential source of finance for essential infrastructure development. South Sudan, on the other hand, is relevant for China in terms of oil imports, and therefore CNPC has the advantage of getting diplomatic support from Beijing in its negotiations with South Sudan.

This study demonstrated the importance of firm-specific political risk analysis, as many of the factors and indicators of political risk that CNPC are exposed to in South Sudan are specific to the oil industry, and other factors and indicators may influence the way CNPC is affected by macro political risk. For example, the shutdown of the South Sudanese oil industry directly affected oil corporations, but only indirectly influenced other industries because of the effect on the country's economy. Furthermore, indicators such as being a Chinese state-owned firm might impact the political risk exposure of that specific firm. The selection of the case study of CNPC's operations in the South Sudanese oil industry proved to be a good example to illustrate the importance of firm-specific political risk analysis and to emphasise the need for firm-specific political risk analysis as a decision-making tool for international businesses operating in foreign countries.

### **5.3.2 *Review of the study***

Two aspects should be mentioned in the review of the study. Firstly, the majority of the articles and studies presented in the literature overview in Chapter One were found to be useful in serving as a foundation for this research. Most of the sources were secondary and this proved to be sufficient for the purposes of the second and third chapters. Some difficulties were found with the availability of information of Chapter Four because of the short period since South Sudan's independence. Some of the statistical data, such as economic data on the balance of payments and current account, was not available for South Sudan from the sources consulted and the data had to

be derived from other information. Other reports still used combined data for Sudan and South Sudan. Furthermore, most data on the oil negotiations were cryptic and it was difficult to identify the influence of all the role-players from the reports. A few recent secondary sources were helpful in this regard, but care had to be taken not to rely too much on one source, as it could limit objectivity in the analysis. As the oil and border negotiations between Sudan and South Sudan were ongoing during the course of the study, it was difficult to make a final conclusion to the assessment of political risk. It should be taken into account that only information up to 31 August 2012 was used and developments afterwards might have an influence on the final risk evaluation, but not necessarily on the answering of the research questions posed by the study.

Secondly, some aspects of Boshoff's (2010) political risk model used as a framework for the analysis should be mentioned in the evaluation of the study. The model proved to be a good basis for firm- and industry-specific political risk analysis for the oil and gas industry as it made provision for both macro and micro political risk factors and indicators in one model. However, some aspects should be noted about the application of the model in the study. Firstly, the model makes provision for the discretion of the analyst in the weighting of political risk factors to calculate an overall political risk rating, but not for the weighting of the indicators that are used to calculate the average risk rating for each risk factor. This proved to be a disadvantage of the model, as it was found by the analysis of the context of the case that some indicators contributed more than others to the specific risk factor, but because no discretion was given to the analyst to adjust the weight of the indicator, the higher contribution was not reflected in the quantitative risk rating of the factor. For example, the shutdown of the oil industry had an extreme impact on the political risk that CNPC might face, but the indicator for political instability was watered down in the political factor risk rating because of lower values attached to less significant issues. The second aspect about the model that should be noted is that some of the indicators overlap when a specific factor is analysed. For example, for the societal factor, indicators such as homogeneity, ethnic conflict and internal violence overlap. Also, the indicators of balance of payments and current account overlap in the analysis of the economic factor. By combining these indicators, a more effective analysis could be made.

These two limitations of Boshoff's (2010) model can be overcome by giving the analyst more flexibility in the weighting of the indicators. The identification of these aspects emphasises the importance of the political risk analysis within a certain context and of using qualitative methods in conjunction with quantitative political risk analysis methods, as suggested by Frei and Ruloff (1988:6).

The next section suggests further areas for research that were identified during the course of the study.

#### **5.4 Recommendations for future research**

The study was limited to an empirical case study on political risk faced by CNPC in South Sudan since the country's independence. More empirical studies can be performed to give better insight in the phenomenon of political risk, specifically with regards to micro political risk. The research on the indicators of political risk that Chinese firms may face in the African oil and gas industry can be extended to other Chinese oil firms and to other African countries, such as Nigeria, Angola or DRC. Since Chinese firms are expanding their investments in other sectors such as construction, telecommunications and retail in African countries, comparative research in other sectors may also provide valuable insight into the nature of political risk faced by Chinese firms in Africa.

More research is also warranted in the area of industry specific political risk models. The scope of this study was limited to the application of a model, and the aim was not to develop a new model. However, as difficulties were found with some of the aspects in the application of the model, it is suggested that with more theoretical and empirical research, the models that are currently available can be streamlined to be able to give a better measurement of a firm's political risk exposure.

Finally, this research study did not include a discussion of risk mitigation and risk management. For Chinese corporations that operate in African countries where they may face high political risk, political risk analyses should be supplemented by risk mitigation and risk management plans. Security and profitability objectives are becoming more relevant for Chinese SOEs as they operate in these high-risk regions. If the political risk can be managed and mitigated, the opportunities that may exist for high returns on their investments may be exploited.

#### **5.5 Conclusion**

The nature of political risk is complex and multidimensional in an integrated world economy where MNCs of developing countries are increasingly investing in operations situated in foreign countries. This is evident from the expansion of the presence of Chinese NOCs in the African continent, where the political environment of the oil producing countries often expose the firms to high political risk. Oil has played a central role in the politics of Sudan since the discovery of oil reserves during the late 1970s, and has been a significant factor in the events leading to the secession of South Sudan in July 2011. As a major investor, CNPC, one of the large Chinese NOCs, was significant in the development of the Sudanese oil industry, and found itself in a difficult position when the largest part of the oil reserves were transferred to South Sudan after the country's independence. These developments changed the political landscape in which CNPC has to operate and may expose the firm to possible political risks. This study analysed the

political risk exposure of CNPC in South Sudan, and found that the firm may face a high level of political risk. However, the political risk exposure was mitigated by certain indicators of political risk such as the economic dependency of South Sudan on China and CNPC. By examining the results of the case study, possible indicators of political risk that Chinese oil firms may be exposed to in African countries were identified. The study demonstrated the complex nature of political risk and the close connection between business and politics. This highlighted the importance of political risk analysis for international business firms as a decision-making tool to justify its investment decisions. Even in high-risk political environments, the African oil industry may provide Chinese NOCs with opportunities of gains if these risks are managed.

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## Appendix A

### Chronology of the conflict and oil development in Sudan, 1850-2011

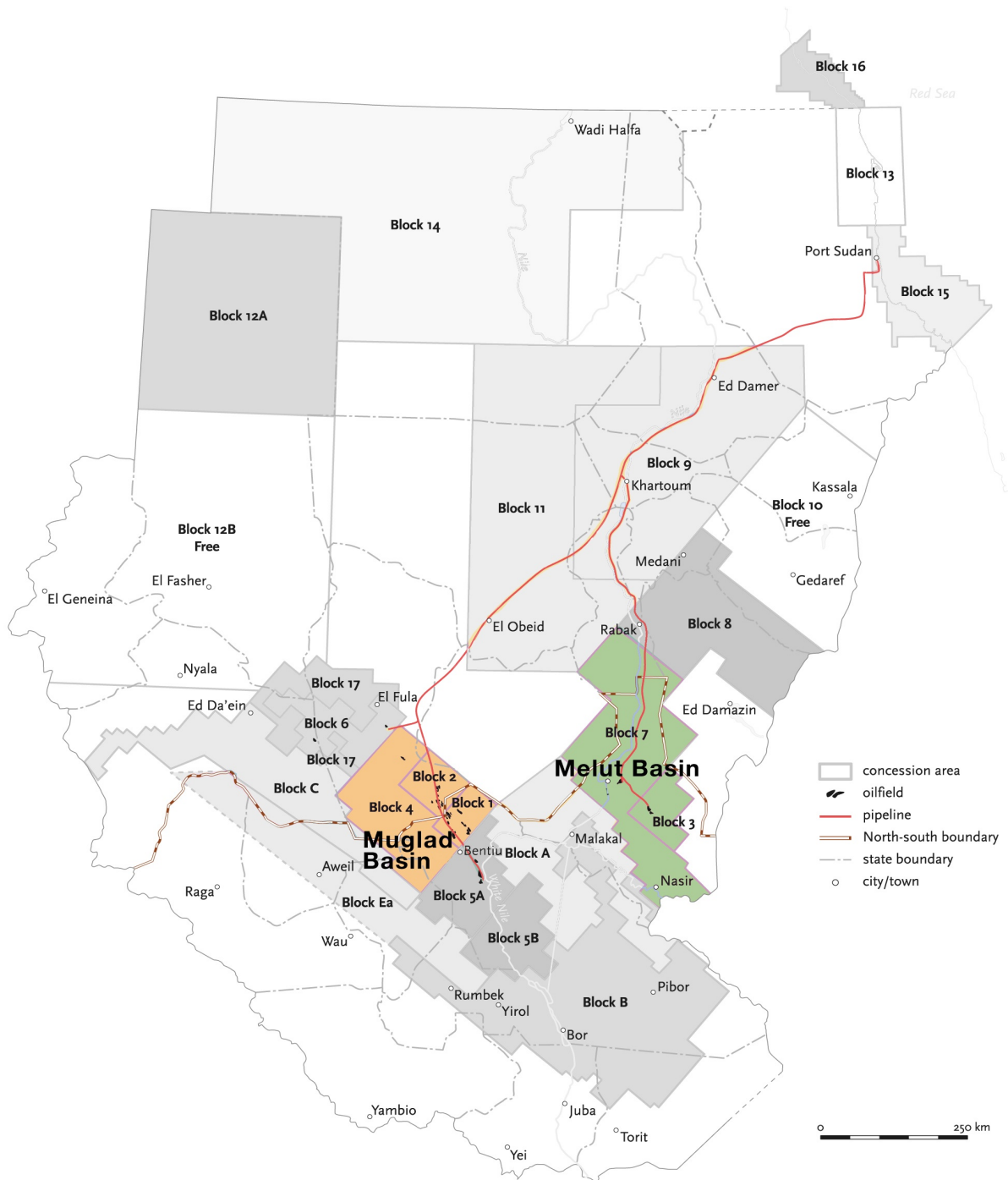
1899 - 1955	<ul style="list-style-type: none"> <li>• Sudan under British-Egyptian rule</li> </ul>
1955	<ul style="list-style-type: none"> <li>• Outbreak of first Sudanese civil war</li> </ul>
1956	<ul style="list-style-type: none"> <li>• Sudan gains independence</li> </ul>
1968	<ul style="list-style-type: none"> <li>• Jaafer Nimeiri comes to power after coup d'etat</li> </ul>
1972	<ul style="list-style-type: none"> <li>• Addis Ababa Peace Agreement grants southern Sudan autonomy</li> </ul>
1978	<ul style="list-style-type: none"> <li>• Oil discovered in the Muglad Basin</li> </ul>
1982	<ul style="list-style-type: none"> <li>• Chevron starts oil development in Muglad Basin</li> </ul>
1983	<ul style="list-style-type: none"> <li>• Powers of southern Sudan eliminated</li> <li>• Sharia (Islamic) Law introduced</li> <li>• Outbreak of second Sudanese civil war</li> </ul>
1984	<ul style="list-style-type: none"> <li>• Chevron suspends oil operations in Sudan</li> </ul>
1989	<ul style="list-style-type: none"> <li>• NIF comes to power after coup d'etat led by Omar al Bashir</li> </ul>
1997	<ul style="list-style-type: none"> <li>• US sanctions against Sudan</li> <li>• GNPOC starts oil production in Muglad Basin</li> </ul>
1999	<ul style="list-style-type: none"> <li>• Sudan begins to export oil</li> </ul>
2003	<ul style="list-style-type: none"> <li>• CNPC discovers major oil field in Melut Basin</li> </ul>
2005	<ul style="list-style-type: none"> <li>• CPA signed by the NCP and SPLM/A</li> </ul>
9 January 2011	<ul style="list-style-type: none"> <li>• Southern Sudanese vote in favour of secession</li> </ul>
9 July 2011	<ul style="list-style-type: none"> <li>• South Sudan gains independence</li> </ul>

**Table Four:** Chronology of the conflict and oil development in Sudan, 1850-2011.

Source: Adapted from BBC News (2012b), ECOS, (2010), Kobrin (2004), Harneit-Sievers (2010) and Large (2008).

## Appendix B

### Maps



**Map One:** Sudan and South Sudan oil blocks.

Source: ECOS (2010).



**Map Two:** Sudan and South Sudan: Heglig oilfields.

Source: BBC News (2012c).



**Map Three:** States of South Sudan.

Source: ICG (2011b).